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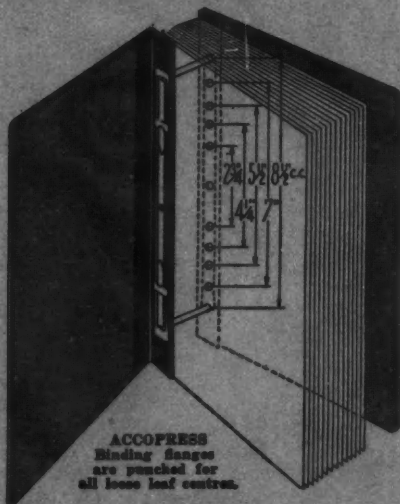
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TAX QUESTIONS IN PARLIAMENT

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### THE TAX REVIEW

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# THE TAX REVIEW

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## BUSINESS PROFITS AND INCOME: INDIVIDUALS

By Melville Pierce, B.A., LL.B.

UNDER THE INCOME TAX ACT, 1948, c. 52, the subject-matter of tax is the income of a taxpayer for the year minus certain deductions (sec. 2(3)), with the provision that the income from a business or property is the profit therefrom for the year (sec. 4). It is important, therefore, to ascertain what are (1) income, (2) a business, and (3) profit from a business. The Act affords some assistance in regard to the second of these. Without defining the word "business" sec. 127(1)(e) declares that it "includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade".

The importance of this inquiry will be apparent when it is considered (1) that under the Act only interest on borrowed money used for the purpose of earning income *from a business* (or property) may be deducted (sec. 11(1)(c)); (2) that the deduction of an outlay or expense is prohibited except to the extent that it was made for the purpose of earning income *from a business* (or property) (sec. 12(1)); and (3) that the deduction of losses of other years is limited to *business* losses (sec. 26(d)).

In pursuit of any inquiry into the distinction between profit from a business and other income it is inevitable that recourse be had to the decisions upon the

British Income Tax Acts, which contain provisions of similar, though not identical, effect. The British *Income Tax Act*, 1918, c. 40 imposes a tax in respect of all property, profits, or gains described in the schedules (sec. 1). Of the five schedules our concern is solely with Schedule D, sec. 1 of which charges the tax on (a) the annual profits or gains arising or accruing from property, or from any trade, profession, employment or vocation, and (b) on all interest of money, annuities, and *other annual profits or gains* not charged under the other Schedules and not exempted. Under Sch. D, sec. 2, tax is charged under 6 cases, viz., *case 1*, in respect of any trade; *case 2*, in respect of any profession, employment, or vocation; *case 3*, in respect of profits of an uncertain value and of other income described in the rules applicable to the case; *case 4*, in respect of income arising from foreign securities; *case 5*, in respect of income arising from foreign possessions; and *case 6*, in respect of any annual profits or gains not falling under any of the foregoing cases and not charged by virtue of any other schedule. Of these six cases, our concern is almost entirely with *cases 1* and *6*.

Two other provisions of the Act are important. The rule applicable to *case 1* reads:

The tax shall extend to every trade car-

ried on in the U.K. or elsewhere . . . and shall be computed on the full amount of the balance of the profits or gains.

Sec. 237 provides:

In this Act, unless the context otherwise requires — "Trade" includes every trade, manufacture, adventure or concern in the nature of trade.

Because of the similarities between our own statute and the British, decisions on the latter are of great value in construing our own Act, but it must be recognized that the only authority which they possess in this country derives entirely from their intrinsic soundness and not because of any rule of *stare decisis*.<sup>\*</sup> Moreover in Britain the jurisdiction of the Courts of law on taxation appeals is confined to questions of law, and it is rare indeed, particularly in England (though less so in Scotland) for the Courts to question the findings of the tax tribunal of first instance (the General or Special Commissioners, a body of laymen) on such questions as whether or not a course of conduct or a particular transaction amounted to a trade, adventure or concern in the nature of trade, though upon occasion the Courts have intimated that they themselves would have found otherwise (see e.g. *Cooper v. Stubbs*, *infra*). Under the Canadian Act there is no such limitation on the appellate jurisdiction of the Courts which hear tax appeals and therefore no hard-and-fast distinction between questions of fact and questions of law is likely to be drawn by our Courts. There is one further consideration to which weight must be attached, that the British Income Tax Acts, which have a legislative history of more than 150 years, arise out of a changing social milieu which is not identical to ours, and the policy of a Legislature and the attitude of the Courts of any country necessarily are related to the conditions and wants of the people of whom, in the larger sense, they are representative.

In comparing the Canadian with the

British Act, note also that the Canadian Act is general where the British Act is specific. Thus whereas the Canadian Act brings into charge all "income" without restriction or limitation of any kind, the British Act charges not "income" but the "profits or gains" specified under 5 schedules and further sub-divided into a number of cases. It would be unwise therefore to assume that the two Acts cover precisely the same field. For instance, it may be of interest that the so-called sweeping-up case in Sch. D of the British Act, *case 6*, which brings into charge all "annual profits or gains" not specified in any other schedule, which, as can be seen, is not in terms restricted to "income" gains or profits, has only been held to have that effect by invocation of the *ejusdem generis* rule of statute construction, viz., that a general item following a list of specific items of similar nature is deemed to relate to matters of the same nature as the specific items. (See *A.-G. v. Black* (1871) 1 T.C. 52; *Leeming v. Jones* [1930] A.C. 415; *Withers v. Nethersole* [1948] 1 A.E.R. 400)

Having regard to these considerations it may be said generally that decisions under Sch. D of the British Act relating to the tax on profits from a trade, profession or vocation or under *case 6* on other annual profits of an income nature will be of considerable value under the Canadian Act, because on these subjects the Canadian Act covers certainly not less, and probably more, than its British counterpart. Whilst the British Act, for instance, provides that "trade" shall include "every trade, manufacture, adventure or concern in the nature of trade" (sec. 237), the word "business" in the Canadian Act (itself a word of wider content than "trade") is declared to include a "trade, manufacture or *undertaking of any kind whatsoever* and an adventure or concern in the nature of trade" (sec. 127(1)(3)).

<sup>\*</sup>*Stare decisis* — the rule or principle that a Court is bound by prior decisions of the

same Court and of Courts of higher jurisdiction.

The following British decisions\* touch on the nature of profits from a trade, adventure or concern in the nature of trade, and of other profits not from such sources but analogous thereto and taxable as being of an income or revenue nature. This last-mentioned group of cases, which are dealt with first, may serve to indicate the nature of income for the purposes of the Canadian Act. One word of caution. Because of jurisdictional limitations a British Court may regard itself as bound to regard a particular course of dealing or transaction as not of a trading character whilst a Canadian Court without any jurisdictional restriction might well take the opposite view on similar facts. This observation applies particularly to such cases as *Cooper v. Stubbs*, possibly the most-often cited case on these questions, and dealt with first.

In *Cooper v. Stubbs* [1925] 2 K.B. 753, Stubbs, a member of a firm of cotton brokers, acting on his own behalf, entered into a large number of speculative transactions in the purchase and sale of cotton futures and made substantial profits in each year for some 8 years. (In one three year period he engaged in 150 separate transactions). The Commissioners held (1) that he did not deal in such transactions so habitually and systematically as to constitute the dealings the carrying on of a trade, and (2) that the transactions were gambling transactions and the profits arising therefrom were not annual profits assessable under Sch. D, *case 6*. Rowlatt J. in the High Court, and Pollock M.R. in the Court of Appeal, held that the Commissioners misdirected themselves in finding that a trade was not carried on, and Pollock M.R. pointed out that having regard to the extended meaning of the word "trade" in sec. 237 it was not a right test in law to apply the

touchstone of habit or system in order to ascertain whether or not a trade was carried on. Warrington and Atkin L.JJ. did not feel that they were warranted in reversing the Commissioners on the question of trade or no trade, but held that Stubbs' profits were in any event properly assessed under *case 6*. Even though the transactions may have been gambling transactions from Stubbs' standpoint, they were not wagering contracts. "The question therefore is simply this," said Warrington L.J., "were these dealings and transactions entered into with a view to producing, in the result, income or revenue for the person who entered into them." Atkin L.J. pointed to the facts that Stubbs had been for 8 years running in receipt of money from the transactions, that he had been making profits or gains not by investing his capital, because he never invested any money in the matter, but by making executory contracts which he closed by other executory contracts, and these he thought were annual profits or gains.

In *Benson v. Counsell* (1942) 24 T.C. 178, twenty racehorse owners formed a syndicate to which they all subscribed money for the purchase of a stallion to be used for breeding purposes, each member receiving a number of nominations proportionate to the amount of his subscription, which he could either use himself or sell on certain conditions. Between 1934 and 1940 one subscriber sold 17 out of 28 nominations. The Commissioners found the receipts not receipts of a trade, but assessed them under *case 6*. Lawrence J. affirmed their decision. This was not, he said, a case of sale and resale of goods; the subscribers merely realised the fruit of the horse (which they had bought) by selling nominations; the receipts were of a revenue nature and chargeable under *case 6*.

A case frequently cited, more often for

\*It may be of significance that all the cases cited in this article were decided following the first Great War, when the tax rates became far heavier than they had been in pre-war years. The number of cases involving

these abstruse issues seems to grow roughly in proportion to the increasing weight of taxation. Perhaps Canada will witness a similar trend.

its *dicta* than for its actual decision (and not always with approval of the *dicta*) is *Ryall v. Hoare* [1923] 2 K.B. 447, a decision by Rowlatt J. In this case, Ryall, a practising solicitor and director of a company, in two successive years gave his personal guarantee of the company's overdraft at the bank in consideration of being paid a commission of 2% on the amount guaranteed. Rowlatt J. said, "I must treat the case as if a person who was not connected with business at all received a commission from another person also not connected with business, in return for the favour of guaranteeing his account at a bank," and held that emoluments arising by virtue of service rendered whether by way of action or permission were profits and gains within the meaning of *case 6*.

A somewhat similar case is *Brocklesby v. Merricks* (1934) 18 T.C. 576, wherein a practising architect introduced an estate-owner to one of his clients, and the latter negotiated a purchase of the estate. Shortly afterwards the client and the architect made an agreement whereby the architect undertook to sell the estate and to perform all architect's and surveyor's work necessarily involved without charge, in consideration of being paid a share of the net profits on resale of the estate. The estate was eventually sold without any part being played by the architect other than the preparation of a layout plan which was not in fact used. He was assessed on his share of the profits under *case 6*. It was held by Finlay J. (affirmed by the Court of Appeal) that the payment was made pursuant to an enforceable contract for services rendered or to be rendered, and was chargeable under *case 6*, it being immaterial that the reason for giving the architect so advantageous a contract was because of his having introduced the estate owner.

Another *case 6* assessment is *Wilson v. Mannooch* (1937) 21 T.C. 178. Here a practising solicitor on two separate occasions procured a loan (in one case partly of his own funds) for a building company client to enable it to purchase

certain property, in consideration of receiving, in the first instance, a share of the resulting profit on resale of the property with a limit of £500, and, in the second case, of being paid a bonus of £300 on resale together with interest at 6% *per annum* on the amount of the loan. Lawrence J. held that the sums paid the solicitor were payments for the finding of money and were assessable under Sch. D, *case 6*.

In *Hobbs v. Hussey* (1942) 24 T.C. 153, Hobbs, a sometime solicitor's clerk, accepted an offer to write his life story for instalment publication in a newspaper, being paid £1500 for the serial rights. He incurred certain expenses in preparing his articles, and was assessed on the net profit. The Commissioners found he was not carrying on the profession or vocation of an author but assessed him under Sch. D, *case 6*. Lawrence J., on appeal held (following a *dictum* of Rowlatt J. in *Ryall v. Hoare*) that profits from a single article by a person who is not an author are assessable under *case 6*. He said:

The performance of services, though they may involve some subsidiary sale of property (e.g. dentures sold by a dentist), are in their essence of a revenue nature, since they are the fruit of the individual's capacity which may be regarded in a sense as his capital but are not the capital itself. The true nature of the transaction [here] was the performance of services, and not a sale of an asset.

In *Graham v. Green* [1925] 2 K.B. 37, Rowlatt J. held that the gains made by a man from betting on horses on a large and sustained scale, by which means he earned his livelihood, were chargeable neither as the profits and gains of a vocation (Sch. D, *case 2*), nor under *case 6*. The winning of a bet, he held, does not result in a profit or gain since there is no connection at all between the event and the acquisition of property, which results from a mere irrational agreement. *Case 6* was therefore not applicable. He further held that the individual operations of a person who placed bets did not merge so as to form

a whole, as in a trade, and accordingly the gains in question could not be charged as the profits or gains of a trade under *case 1*. One passage in this judgment is worth quoting:

A person who buys an object which subsequently turns out to be worth more than he gave for it, and which he sells, does not thereby make a profit or gain for income tax purposes. But he can organise himself to do that in a commercial and mercantile way, and the profits which emerge are taxable profits, not of the transaction, but of the trade.

The next group of cases are all concerned with the purchase and sale of property. It will be noted that much turns upon whether the transaction stands isolated and alone or is one of a series of transactions. In the former case the issue is clear, in the latter case some difficulties arise as to the proper determination.

In *Pearn v. Miller* (1927) 11 T.C. 610, Pearn, a director of a building company, acting upon his own account, purchased and repaired some 7 estates over a period of some 5 years. Of these he sold 4 properties, in each case at a profit. An assessment was levied on him under Sch. D, *case 6*. Rowlatt J. remitted the case to the Commissioners to find whether Pearn was carrying on a trade, adventure or concern in the nature of trade so as to be assessable under *case 1*. A profit on the purchase and sale of property can only be taxed, he held, if it is a trade, adventure or concern in the nature of trade, and he pointed out a significant difference in result between an assessment under Sch. D, *case 1* and one under *case 6*. An assessment under *case 1* upon a trade involved a proper stock-taking account, with valuations and losses brought in, whereas an assessment under *case 6* was concerned only with the profits on the transaction without taking into account losses incurred and valuations.

The leading case on this subject is *Leeming v. Jones* [1930] A.C. 415, a decision of the House of Lords. In this

case Leeming and other persons acquired an option over a rubber estate in Malaya with a view to its resale to a company to be formed for that purpose. A month later they acquired an option over an adjoining estate with the same object. Subsequently they transferred the two estates to a company formed for that purpose, making a profit on the whole transaction. The Commissioners found that the transaction was not a concern in the nature of trade under *case 1*, and the Crown, while not contesting this finding, sought to hold the profits assessable under *case 6*. The Lords held that the profits and gains assessable under *case 6* must be of an income or revenue character, and they concurred in Lawrence L.J.'s *dictum* in the Court of Appeal ([1930] 1 K.B. 279 at p. 302) viz.,

It seems to me in the case of an isolated transaction of purchase and re-sale of property there is really no middle course open. It is either an adventure in the nature of trade, or else it is simply a case of sale and resale of property.

*Cooper v. Stubbs* (*supra*) was distinguished and approved.

In *Lowry v. Field* (1936) 20 T.C. 679, a number of individuals subscribed moneys to certain ventures undertaken by a mining exploration and development company, their intention being to acquire shares in any companies which might eventually be formed to take over such properties as held good prospects of development. In the case of two subscribers the Special Commissioners held that they were not carrying on a trade or adventure in the nature of trade, but they held the profits chargeable under *case 6*, whilst a board of General Commissioners hearing an appeal by two other subscribers held them chargeable under neither *case 1* nor *case 6*. On appeal to the High Court it was not contended that the appellants carried on a trade, and Lawrence J. held that the profits made were capital profits and not chargeable to tax under *case 6*. It was, he said, a case of investment of money, and added



I am inclined to think that wherever there is an investment of money there must be a possibility of the profit upon that money recurring for it to be a revenue profit . . . . In my view that reasoning harmonises with the cases which have held that recurring profits where there is no investment of money may be of a revenue nature, the conception being that the capital there involved is nothing more than the individual's efforts, and the individual's efforts always being capable of recurring, the profit which is derived from the individual source is treated as being a casual profit which may fall under case 6. It seems to me to agree with the principle of the decision in *Cooper v. Stubbs* (supra) . . . .

In *Reynolds v. Bennett* (1943) 25 T.C. 401, Reynolds, who was in the motor business, purchased a 56 acre farm near London, and a year later purchased some adjoining land to provide entry to the former from the road. A few months later he sold the two lots to an estate development company at a substantial profit. Nearly two years later he bought another large property and soon after sold it to an estate development company at a substantial profit, the land being transferred, for the purchaser's convenience, in 6 separate lots. In each case Reynolds as soon as he had bought the land, took steps to dispossess the tenants, but did not develop the land or attempt to sell. Prior to these transactions he had engaged in the purchase and development of building land in partnership with another man and sold the whole of it in building lots over a period of four years, paying income tax on the profits derived therefrom. Macnaghten J. upheld the decision of the Commissioners that in his purchase and sale of the two estates Reynolds was engaged in an adventure in the nature of trade and that the profits were chargeable to income tax under case 1.

In *Williams v. Davies and Nisbet* (1945) 26 T.C. 371, two men in business as buyers and sellers and developers of building land arranged a scheme to enable their wives to make a good profit. They bought a plot of undeveloped

building land and each transferred his half by deed of gift to his wife, who, thereupon, on her husband's advice, sold the land at a profit to a development company of which the two husbands were the only directors and shareholders. About two years later they repeated the transaction. The wives were assessed to income tax for each of such years, but the Commissioners discharged the assessments, holding them assessable neither as carrying on a trade or adventure under case 1, nor under case 6. On appeal, Wrottesley J. said he was unable to hold that there was no evidence to support the Commissioners' finding that a trade was not carried on. He said:

If a trader chooses to give part of his stock-in-trade to a person and to find him a customer for it at a profit, that does not necessarily expose that person to income tax in respect of that profit. And if the gift be genuine, as I must assume here, the mere fact of doing it twice over will not make that inference inevitable, thought it may make it more likely.

Then, on the question whether the wives' profits were annual profits or gains chargeable under case 6, he cites *Leeming v. Jones* (supra) as authority for the proposition that if trading is negatived in the case of purchase and sale of land at a profit, it must be capital accretion; there is no halfway house. In the instant case, he said, there was not even the first step which existed in *Leeming's* case, namely, purchase; but instead a gift. Bearing that in mind, and that there were two isolated transactions, it was, he thought, a question of fact whether the two sales at a profit could be said to have provided annual profits or gains so as to be of the nature of income; and the Commissioners had found that they did not.

The following cases are all concerned with some exceptional transaction or course of dealing outside of the taxpayers' usual course and possessing some *indicia* which mark it as an adventure or a concern in the nature of trade or as a trade simply.

In *Martin v. Lowry* [1927] A.C. 312,

Martin, who was a merchant of agricultural machinery, purchased 45,000,000 yards of surplus government aircraft linen, rented an office for a period of 8 months and set up a large and skilled organization for disposing of it in smaller quantities. He sold 35,000,000 yards to 55 wholesale firms in Belfast, 5,000,000 yards to 208 export firms and the remainder to 1017 retail firms. In about 7 months he disposed of it all at a large profit. The Commissioners found that he was carrying on a trade or business. On appeal it was held by the House of Lords that there was evidence to support the Commissioners' finding. Lord Cave said, "Indeed, having regard to the methods adopted for the resale of the linen, to the number of operations into which the appellants entered and to the time occupied by the resale, I do not myself see how they could have come to any other conclusion."

In *C.I.R. v. Livingston* (1926) 11 T.C. 538 a ship repairer, a blacksmith, and an employee in a firm of fish salesmen jointly purchased a cargo vessel for £1100 in Sept. 1924 with a view to its alteration and sale. They ordered extensive repairs and alterations to convert it into a steam drifter, and the ship repairer and blacksmith employed themselves in the work at regular wages. The ship was sold on completion of the work in Dec. 1924 for £3425 at a profit of £963. The Commissioners held that the profit was not made in the operation of a business ordinarily carried on by the respondents. On appeal to the Court of Session (Scotland), the Court unanimously agreed that the profit was assessable under Sch. D, case 1. Clyde L.P. said, citing *Martin v. Lowry* (*supra*):

I think the test which must be used to determine whether a venture such as we are now considering is, or is not, 'in the nature of trade', is whether the operations involved in it are of the same kind, and carried on in the same way, as those which are characteristic of ordinary trading in the line of business in which the venture was made . . . The profit made

by the venture arose, not from the mere appreciation of the capital value of an isolated purchase for resale, but from the expenditure on the subject purchased of money laid out upon it for the purpose of making it marketable at a profit. That seems to me of the very essence of trade.

Lords Sands and Ashmore expressed a similar opinion, and Lord Blackburn was impressed by the fact that two of the respondents were engaged in their ordinary trade in carrying out the alterations and looking to the profit which would result from the sale of the ship for their remuneration.

In *Rutledge v. C.I.R.* (1929) 14 T.C. 490, another Scottish case, a moneylender with extensive interests in other businesses, principally real property, while in Berlin on the affairs of a cinema company of which he was a director was put into touch with a man who was interested in finding money for German firms. Through him he made a deal with a bankrupt firm of paper manufacturers to purchase 1,000,000 rolls of toilet paper for £1000. He paid £100 deposit and arranged for the paper to be sent in four lots every two weeks commencing in Sept. 1920. On his return to London he made efforts to find customers for the paper and got into touch with a man who offered him 3d a roll delivered in London. He accepted this offer and gave him the bill of lading for the first consignment, receiving £500 on account, which he remitted to Germany. About two weeks later he delivered the second bill of lading, receiving £5000, of which he remitted £500 to Germany. The same procedure was followed with the further consignments. His net profit on the whole deal was nearly £11,000. The Commissioners found that the profits were those of a concern in the nature of trade within Sch. D, case 1. The Court of Session held that having regard to the facts that appellant's intention was to resell the paper at a profit, the large quantity of paper purchased, and the manner in which the transaction was carried out, i.e., in the same manner as a



regular trader would carry out a similar transaction, it was an adventure "in the nature of trade", and chargeable under case 1.

In *Lindsay v. C.I.R.* (1932) 18 T.C. 43, Lindsay, a wine merchant in possession of a large quantity of American rye whisky, invited two other men, also in the wine trade, to join with him in a venture of shipping the whisky to the U.S. The two other men agreed to share in the expenses and receive a share of the profits, but took no part in directing the enterprise. Lindsay shipped the whisky to the U.S. gradually over a period of two years. The Commissioners found that the transactions were in the nature of trade and the profits assessable under case 1. The Court of Session, following *Rutledge v. C.I.R.* (*supra*) affirmed their decision on appeal. Clyde L.P. pointed out that the transaction was in its nature the commercial disposal of a quantity of rye whisky effected not by a single transaction but over a year and more. Lord Blackburn pointed to the fact that the participants were wine merchants.

In *C.I.R. v. Fraser* (1942) 24 T.C. 498, Fraser, a woodcutter by occupation, made three purchases of a considerable quantity of whisky in bond over a period of a year, and sold it about two years later at a profit. He had no previous or subsequent dealings in whisky; he did not take delivery of it or have it blended or advertised. The Commissioners found this not to be an adventure in the nature of trade but a mere realisation of an investment. The Court of Session, however, thought otherwise and allowed the Crown's appeal. They held that while the transaction was not a trade it was an adventure in the nature of trade. Lord President Normand said:

It would be extremely difficult to hold that a single transaction amounted to a trade, but it may be much less difficult to hold that a single transaction is an adventure in the nature of trade. It is in general more easy to hold that a single transaction entered into by an individual in the line of his own trade (although not part and parcel of his own business)

is an adventure in the nature of trade. But what is a good deal more important is the nature of the transaction with reference to the commodity dealt in,

and he pointed out that the purchaser of a large quantity of a commodity like whisky (as distinct from a painting or land which afforded pride of possession), greatly in excess of his personal requirements, could scarcely be other than an adventurer in a transaction in the nature of trade. Finally he said, "Most important of all, the actual dealings of the respondent with the whisky were exactly of the kind that takes place in ordinary trade."

The most recently decided case is *Smith Barry v. Cordy* (1946) 28 T.C. 250, which appears to go farther than any of those previously cited. In this case the appellant, a mathematician and a man of wealth, having decided to spend the whole of his capital (about £100,000) during his lifetime, worked out a careful scheme for the purchase of endowment policies on other persons' lives which would provide him £7000 a year until he was 60. He then had his solicitor purchase selected policies at regular fortnightly auctions of such policies over a period of about 18 months. Some years later he decided to take up permanent residence in India for his health and in consequence gave a number of the policies to his brother-in-law and sold the remainder for an amount in excess of their cost. He was assessed for each of the years 1938-39 to 1942-43 on the accretions arising during each of such years. The Commissioners held that having in mind the number of purchases made over a period of 18 months, together with the manner in which the policies were selected and purchased in pursuance of an organised scheme, that appellant engaged in a concern in the nature of trade resulting in profits — the fruit of the capital laid out.

The Court of Appeal (reversing Macnaghten J.) affirmed the assessment under Sch. D, case 1. They held that the word "trade" in Sch. D, as defined by

sec. 237, had a wide scope, and that having regard to the elaborate way in which appellant calculated out the annual yield of all his purchases and the very large number of policies bought and the fact that these were not ordinary investments, case 1 was the appropriate case under which to charge him. They agreed with Pollock M.R.'s judgment in *Cooper v. Stubbs* (*supra*), while conceding that the profit might also be "annual profits or gains" within case 6 as held by Warrington and Atkin L.JJ. in that case. Scott L.J. said:

To bring a single transaction within case 1 it must bear clear indicia of 'trade' [Martin v. Lowry; Rutledge v. C.I.R., *supra*]. Unless *ex facie* the single transaction is obviously commercial the profit from it is more likely to be an accretion of capital and not a yield of income. But that question is almost necessarily one of

fact. On the other hand to bring a source of profits within the meaning of 'trade' in case 1 it is not necessary to show the presence of a regular business of buying and selling.

Appellant, he said, made up his mind to utilise the commercial market in endowment life policies to assure himself a means of livelihood at the average rate of £7000 a year over a long period. He showed great mathematical skill — an element in the business of an average adjuster, an underwriter, a banker or a financier. He continued to make his purchases in the commercial market over a period of 18 months, i.e., until he had planted enough trees to yield him the fruit he wanted over the series of seasons for which he was making the purchases. This, he said, amounted to both an 'adventure' and 'trade'.

## DIVIDENDS FROM CAPITAL PROFITS ARE INCOME

ALTHOUGH THE REVENUE OFFICIALS in this country have always taken the view that a dividend paid by a company as a going concern is income in the hands of the shareholders even though paid out of a capital profit, doubts have occasionally been expressed as to the correctness of this stand. A recent decision of the House of Lords, *Commissioners of Inland Revenue v. Reid's Trustees* [1949] T.R. 45, rendered on January 29th goes a long way (if not the whole way) in support of the Revenue's attitude.

In this case Reid's trustees held shares in a company incorporated and carrying on business in South Africa as iron and steel merchants. In 1943 the company sold at a profit certain out-of-date stores and offices used in connection with its business, and the directors declared a dividend of 20% out of the "capital profits" so realised. Reid's trustees were assessed in respect of the dividends re-

ceived by them on the ground that they were "income arising from a possession out of the United Kingdom" within the meaning of Schedule D, case 5 of the *British Income Tax Act, 1918*, c. 40. The Court of Session (Scotland), affirming the decision of the Special Commissioners, discharged the assessment, and held that the dividends were not the income of anyone. On appeal to the House of Lords the decision was reversed unanimously.

Counsel for the trustees sought to draw an analogy between the taxation of a British company and its shareholders and the taxation of a foreign company (as in the instant case) and its shareholders. In the former case a dividend paid out of capital profits would not be assessable in the hands of the shareholders, because under the British scheme of taxation the company is only chargeable on its trading profits and deducts tax at the standard rate only on dividends paid out of

such profits. Their Lordships rejected outright this argument based on analogy, pointing out that unlike a shareholder in a British company a shareholder in a foreign company is directly assessable to tax in respect of dividends he receives.

On the main question, whether the dividend paid out of capital profits was income arising from a foreign possession, none of their Lordships expressed the smallest doubt. Lord Simonds said that the opposite conclusion could only be reached by ignoring that what may be regarded as capital in the hands of the payer may yet be income in the hands of the payee. The dividends in question were paid in respect of shares in the

capital stock of the company which itself remained intact, and they could not, as their Lordships saw it, be anything but income from such shares. As Lord MacDermott put it: "This dividend then, was income arising from the respondent's shareholding, and the question accordingly reduces itself to this: Is it permissible, in order to determine the liability of the dividend to tax in the hands of the . . . shareholders, to look beyond the immediate source, the shareholding, and to examine the make-up of the profits out of which the dividend has been declared? In my opinion, the answer must be in the negative."

## IN PARLIAMENT

March 31

### BASIS OF QUARTERLY PAYMENTS FOR 1949

G. K. Fraser (P.C., Peterborough West): Since this is the last day for the payment of the first quarterly instalment on income tax for 1949, can the minister tell the house whether new quarterly payment forms, T.C. 7B, are to be made out in accordance with the new budget? If so, when will they be distributed?

Hon. J. J. McCann (Minister of Nat. Rev.): The forms which are available at the present time were based on the assumption that the rates of last year would be in operation. I suggest that those who make out the quarterly form should use the old form, but take into account the new deductions and new rates as outlined in the budget speech.

March 31

### DEDUCTIONS FROM TAXABLE INCOME OF WAGES PAID TO CHILDREN OF TAXPAYER

J. G. Diefenbaker (P.C., Lake Centre): The other day the director general of assessments, Mr. Cotter, speaking on the farm forum broadcast, stated that there is no reason why farmers should not employ their children on their farms and pay them wages, and thereby be permitted to deduct such expenditures paid to their children in arriving at their income tax. He further stated that if no more than \$400 was paid to any one child under that arrangement, the child would still remain a dependent. My ques-

tion is this: Has any change been made in the income tax regulations which will permit a farmer to hire his own children and, upon producing receipts, to deduct those amounts in arriving at his net income? If so, will this apply to the 1948 income tax returns of farmers generally throughout the country? This is a matter of importance.

Hon. J. J. McCann (Minister of Nat. Rev.): It is a fact that, under the circumstances outlined by Mr. Cotter, that condition can obtain. It should be kept in mind that it is permitted that the children, instead of outside help, are employed in productive labour, and that they are paid in cash. It must also be kept in mind that if those earnings exceed \$400 the child ceases to be a dependent for taxation purposes. The \$400 is applicable in years up to January 1, 1949; and if the new budget passes as we all hope it will, the amount is increased to \$500.

Hon. W. E. Rowe (P.C. Dufferin-Simcoe): In view of the answer given by the Minister of Nat. Rev., can he tell the house how old a child must be before a farmer may include him in his salary list?

Mr. McCann: I have had no notice of the hon. member's question. I suggest that it is a sort of catch question. I would say, however, that he should be a child of such an age that his services would be of some use to his father.

Mr. Rowe: About six or seven.

T. H. Ross (L., St. Paul's): May I ask the Minister of Nat. Rev. if the same regulation will apply to the children of storekeepers, and so on?

Mr. McCann: Yes.

March 31

REFERENCE TO ASSESSMENT  
ALREADY MADE OF 1948 TAX

S. Knowles (C.C.F., Winnipeg North Centre): May I be permitted to adopt the unusual practice of paying a compliment to the Minister of Nat. Rev.? We do not hesitate to complain about delays, but I hold in my hand the official assessment of my income tax for 1948. It is not even due until the end of the month, but it is finalized already. The speed of his department in this instance overwhelms me.

April 5

FARMERS—STATEMENT AS TO  
DEPRECIATION ALLOWED ON HOUSES

Hon. J. J. McCann (Minister of Nat. Rev.): As reported at page 2229 of Hansard of April 1, the hon. member for Provencher (Mr. Jutras) requested—

—a full statement . . . as to any additional consideration now being given farmers with regard to the allowance for depreciation on the farm house because of the preponderant part it plays in the farm business; and also as to the basis on which it is to be calculated.

My answer is this: In view of the large

part which the farm home plays in the conduct of the farm business, it has been decided that commencing in 1948 a farmer who resides on the farm may claim depreciation on the cost of the farm house at one-quarter of the usual rate of depreciation, and may also claim one-quarter of the cost of repairs to the house, in addition to the full amount of the cost for light, power, taxes, telephone and fire insurance. As indicated, the basis on which this depreciation will be calculated is on the cost of the farm house.

E. G. McCullough (C.C.F., Assiniboia): Is any provision made for depreciation of farm houses which are used fully for hired help, in addition to the allowance now allowed for farm houses?

Mr. McCann: That matter has not been taken into consideration. The statement which I made took into consideration only the farm home.

QUESTION AS TO  
EXEMPTION OF UNION DUES

S. Knowles (C.C.F., Winnipeg, North Centre): I wish to direct a question to the Minister of Nat. Rev. Since trade union dues are in the nature of a business expense, will the government consider allowing them as an income tax deduction?

Hon. J. J. McCann (Minister of Nat. Rev.): That is a matter of policy, Mr. Speaker. When a change is made, it will be announced.

## NOTICES

The Department of National Revenue announces:

An Income Tax District Office was opened in the Province of Newfoundland on the 1st April, 1949. The new District will be known as the Newfoundland District and will serve the whole of the Province of Newfoundland. Communications should be addressed to:

The Director of Income Tax,  
Duckworth Building,  
St. John's, Newfoundland.

The Kingston District Office has been moved from the Customs Building to the Chown Building, Kingston, Ontario. Communications should now be addressed to:

The Director of Income Tax,  
Chown Building,  
Bagot Street,  
Kingston, Ontario.

## THE INCOME TAX REGULATIONS

### Amendments to Part I

Part I of the Income Tax Regulations and Schedule A thereto as made and established by Order in Council P.C. 150 of January 18, 1949, are revoked by Order in Council P.C. 1423 of March 24, 1949 and a new Part I and Schedule A thereto substituted therefor effective March 24, 1949.

The new Order in Council is as follows:

#### P.C. 1423, March 24, 1949

HIS EXCELLENCY the Governor General in Council, on the recommendation of the Minister of National Revenue and under the authority of sec. 106 of The Income Tax Act, 1948, c. 52, is pleased to order as follows:

1. The Income Tax Regulations Part I, and Schedule A thereto, made and established by Order in Council P.C. 150 of January 18, 1949, are hereby revoked, effective as of the date hereof; and

2. The annexed regulations entitled "The Income Tax Regulations Part I", and Schedule A thereto, are hereby made and established, effective as of the date hereof, in substitution for the Regulations and Schedule hereby revoked.

*Canada Gazette, April 27, 1949*

The Regulations so substituted are in the same terms as the Regulations revoked [*Tax Rev.*, p. 37] except as follows:

#### Sec. 102(1)

Following the words "Table of Tax Deductions" insert the words and parentheses "(Table 6)".

#### Sec. 104(2)

Sec. 104(2) has been amended to read:

104(2) Where an amount is determined in accordance with subsec. (1), sec. 102 of these Regulations is not applicable.

#### Sec. 105

Sec. 105 has been revoked in toto and the following new section substituted therefor:

105. (1) No deduction shall be made

under sec. 44(1) of the Act in respect of

- (a) an employee who will not receive in the calendar year total remuneration in excess of exemptions;
- (b) an employee who is a resident of the United States of America temporarily employed in Canada for a period or periods not exceeding a total of 90 days in the calendar year and whose total remuneration from employment in Canada will not exceed \$1,500 in such year.

(2) Subsec. (1) of this section shall not apply unless the employee files with the employer a return in prescribed form.



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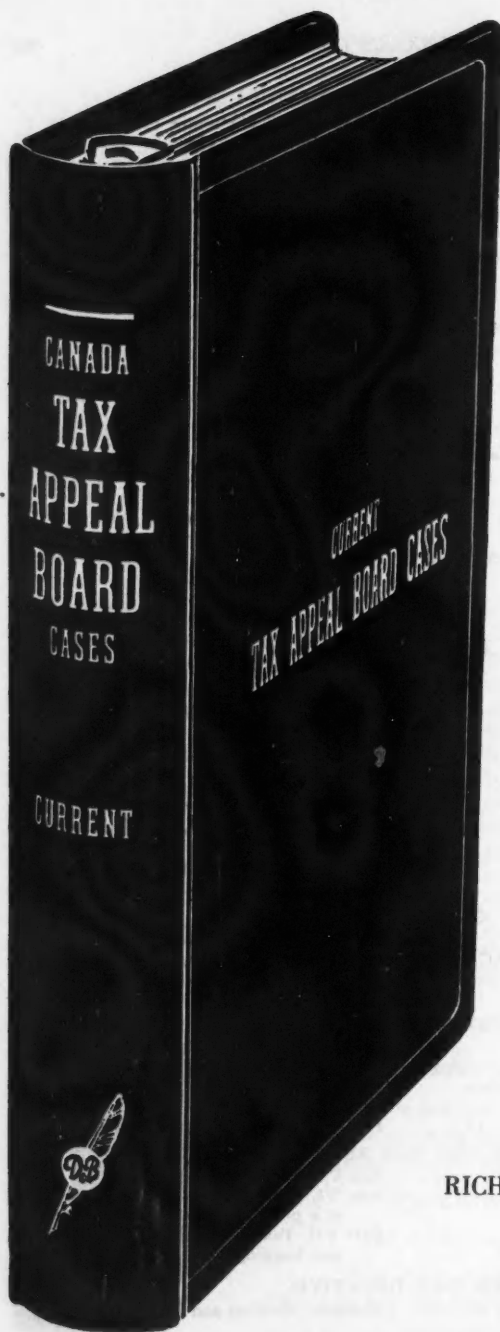
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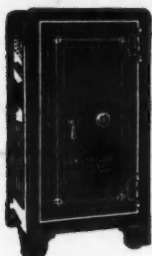
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## COMMENT AND OPINION

### A Matter of Definition

WE RECALL that, when we were at school and at college, the stock answer to a question, which we might put as to why such and such a thing was so, was that it was so by definition. One had to have a basic starting point determined by no other reason than that it was accepted by convention.

A very few of our readers will recall Professor Iva E. Martin, Director of Studies of the Royal Military College of Canada, who was one of the most brilliant and interesting teachers of mathematics in Canada in the first 25 years of this century. In addition to these posts, which he insisted he held by definition only, that is, because someone said that he was Director of Studies and someone said that he was to be professor of mathematics, he had a self-assigned duty, which was to teach the gentlemen cadets how to be gentlemen. His whole basis in these endeavours was to find a fundamental; every problem, whether of a mathematical nature or one of discipline or morality, could be reduced to the fundamental "By definition — or by convention — (as the case may be), this thing was so, or this thing was done or it was not done". There was to be no argument about it.

The fundamental definition to be learned by us was that the sine of an angle was the opposite side divided by the hypotenuse, the cosine was the adjacent side divided by the hypotenuse and the tangent was the opposite side divided

by the adjacent side. Once we had that firmly in our minds, we would readily see that the formula  $\sin^2 a + \cos^2 a = 1$  was the most fundamental truth to be remembered in all our future experience. And when it seemed to us that this rock was about to teeter, we would be along to a preliminary study of differential calculus and come up to a better "most fundamental truth", which was that "the differential of a constant is zero". This is, of course, a great deal more obvious than the first one and is the real rock upon which all students of advanced (?) mathematics found their future solutions of all difficulties. A constant is a constant and nothing you may do to it will make it either more or less.

Just by the way, Professor Martin, a rotund six-footer, used to impress these truths on us by pulling from his right-hand waistcoat pocket at the nether end of his watch-chain a small silver pocket-knife, which he insisted had been given to him by a grateful ex-cadet, upon which these 2 formulae were delicately engraved on the 2 sides. Just so long as these were remembered, we would never fail in mathematics, we would never commit such social errors as throwing peanut shells down the Commandant's neck at a hockey game, or swinging our belts at the Queen's supporters at a football game, or serving a cup of tea after allowing it to slop over into the saucer, or leaving the tea-party without thanking the hostess, even if it was a duty call and



we hadn't enjoyed ourselves anyway as we would much rather have been calling upon young ladies in Kingston.

This, then, is the basis for what appears to be our intolerance at suggested monkeying with definitions, which we learned early in the days of our accounting career. To our mind, one might as well say that a debit is henceforth to be a credit as to vary our definition of depreciation as being an estimate of the historical cost of facilities used up in production. If something else is to be added as a charge to income for some reason other than amortization of historical cost on a pre-determined basis, let us have some other factor based upon a second or new concept without altering the premise of a definition because of a turn in the times.

#### Minimum Disclosure

**B**ULLETIN No. 1 of the Accounting and Auditing Research Committee of the Dominion Association of Chartered Accountants was not intended to reflect any views of the Committee on published accounts of banks, public utilities, insurance companies, railroads, etc. This journal has, however, previously expressed the view that to a large extent these special types of enterprise can and should conform to the standards advocated.

In *Saturday Night*, April 12, 1949, we find as an advertisement the financial statement at December 31, 1948 of the

American Automobile Insurance Company, St. Louis, Missouri, which company does business in Canada and therefore might be expected to provide information to our residents. The bald caption "Stocks of Subsidiaries \$10,493,266.76" covers nearly one-sixth of the total admitted assets and slightly more than half of the combined capital and surplus.

It seems to us that internal investments of these proportions call for some description or explanation in published statements.

#### Balance Sheet Arrangement

**A**LUMINIUM Limited, in its consolidated balance sheet at December 31, 1948, places its "Reserves for Amortization, Depreciation and Depletion of Lands, Plants and Facilities" for the first time on the liabilities side of the sheet. This item represents nearly 50% of the total of that side of the sheet and the item "Lands, Plants, Riparian Rights and Facilities, at cost" represents about 72% of the same total. The president of the company, in a brief statement, says that, in the opinion of the directors, this change contributes to a clearer accounting presentation of the financial statements and should better enable us to determine the state of the company's affairs and the position of the business under present-day conditions. We wonder if it does and, if so, why?

#### Dulce et Decorum Est Pro Patria Mori

**WE** THINK that the chairman of The Matador Land and Cattle Company, Limited took a great deal upon himself when he told the shareholders (as reported in *The Economist*, April 9, 1949)

that "broadly speaking the herds, the ranches and their equipment are in fine condition and fit to face the uncertain future with confidence".

# Is the Auditor's Prime Responsibility to the Company's Shareholders or to the Public?

By Arthur E. Green, C.A.

As a member of a professional body, the accountant has a responsibility to the public as well as to his client

## Arguments in favour of the shareholders

ONE might say to begin with that the auditor has no responsibility to the public, that the auditor is not concerned with any person, organization, group, etc., other than his client, the shareholders or stockholders. The shareholders appoint him, he reports to them and, most important, his account for fees is paid by them, or at least is recommended by them to the management for payment. One could justly argue that having performed his duties to the best of his ability, having then stated his opinion, favourable or otherwise, to the shareholders, that is the end of the matter. It would seem, to state the matter simply, that without question the auditor's prime or original responsibility is to the company's shareholders. From the practical viewpoint of a public accountant whose living is earned by rendering services to his clients, it would hardly seem otherwise.

There is an English case — *LeLievre and Dennes v. Gould*, 1893: The judge, Lord Esher, said:

The question of liability for negligence cannot arise at all until it is established that the man who has been negligent owed some duty to the person who seeks to make him liable for negligence. What

duty is there when there is no relation between parties by contract? A man is entitled to be as negligent as he pleases towards the whole world if he owes no duty to them.

This case involved not an auditor but a surveyor, but the principle is the same. Apparently a builder employed a surveyor, and the mortgagee of the property, acting upon the surveyor's certificate, which was untrue, suffered a loss.

Auditors are appointed by the shareholders in both Canada and the United Kingdom, and report to them. In the United States they may be appointed by either the stockholders or the board of directors, and the auditors' report is addressed accordingly.

The investment editor of *The Financial Post*, in reply to a recent letter concerning the title of this article, said:

I think the responsibility of a company auditor is pretty well determined by the *Companies Act* of the Dominion and the various Provinces. In each of these Acts it is indicated that the auditor shall make a report to the shareholders and consequently his responsibility is to the shareholders. It would seem to me that auditors are appointed as a protection for shareholders to enable them to ensure that the directors and officers are running the company in the shareholders' interest.

### Argument in favour of the public

However, the question is not answered as easily as it would at first appear. Chartered accountants and certified public accountants and others are members of a profession. Webster defines a profession as "a calling or vocation, especially one that requires a learned education; collective body in a calling". As members of a profession it behooves us to conduct our affairs in a manner which is professional. We are not in the business of manufacturing or selling merchandise, although one would imagine that some of our clients must think that it is merely necessary to turn a crank, push a button, or wave a wand in order to produce a set of financial statements, to which is appended the auditor's unqualified report.

Modern society is not as simple as it was in the time of our grandfathers. In this technological, power and now atomic age, people are bound together inseparably. The frontier days are gone and one would probably starve to death as a "rugged individualist". Co-operation is the keynote of the hour.

In such a society, more so than ever in history, rules of conduct are a requisite as otherwise confusion reigns. A professional group must necessarily have its code of rules and regulations for the protection and general welfare of its members and the public. Public accountants have recognized these principles in the rules of professional conduct laid down by the various institutes or societies, whether in Canada, Great Britain or the United States of America. As John L. Carey points out in his book "Professional Ethics of Public Accounting":

Rules of professional conduct have this distinction from other types of conduct; they are designed not only to advance the group interest of those who constitute the profession but also the interests of

those who are served by members of the group,—that is, the public. This is not wholly altruistic. It stands to reason that the opportunity of a profession to serve the public will be widened if the public is convinced that the members of the profession are required to protect the public interest.

The very name "public accountant" emphasizes the primary function of the calling as servants of the public. Julius Henry Cohen in his book "The Law, Business or Profession" says:

A profession is a means of serving the public. In connection therewith the professional man seeks to make his living. Business is a means of making a living. In connection therewith the business man seeks to serve the public.

The distinction drawn in these definitions is the professional man's primary obligation to the public. In recognition of these obligations and to protect the public, certain yardsticks have been evolved by which lack of professional integrity and intellectual honesty may be recognized. However, important though the written code of ethics is, it is not so important as the unwritten rules. In fact, the mere definition of a profession imposes on the professional man a *noblesse oblige* which should reduce rule-making to a minimum.

Mr. Carey also points out that, insofar as the public accounting world is concerned, this generally accepted principle is probably more applicable than in the case of doctors, lawyers, and other professional men. The services which the latter render are usually of immediate concern only to the person who receives them, but the services of a chartered accountant or certified public accountant, which consist largely of expressing opinions on financial statements, are frequently of as immediate concern to large numbers of persons who never see the auditor as they are to the client himself. This would seem then to be the crux of

the matter insofar as auditors' responsibilities are concerned. To state the problem simply, he can never be certain to what use the financial statements upon which he has expressed an opinion may ultimately be put.

It follows from the above that the chartered accountant's responsibilities are indeed onerous and not to be taken lightly. This is the principal reason that students are subjected to such a rigorous course of instruction, training and examination tests. Through patient and painstaking effort in the past by the pioneers of the professional accounting societies, the public, the business and financial world, have come to accept the opinion of a chartered accountant or certified public accountant as almost infallible. This position of professional prestige is one which must be maintained at all costs, and, if possible, advanced to even greater heights. This can only be accomplished by consistently reporting the facts to our clients, and thereby indirectly to the public, whatever the financial cost may be to individual practitioners. The accountant must be independent, and it should be axiomatic insofar as the public is concerned that he tells the truth without fear or favour.

We might at this point discuss at some length of whom "the public" consists.

#### The Department of National Revenue

Throughout the long course of history involving man's gradual conquering of nature and the exploitation of the earth's natural resources, he has gradually and painstakingly acquired more and more comforts and a higher standard of living. At first only a few privileged barons, dukes and warlords could have these comforts, as this was an age of scarcity. From the time of the industrial revolution down to to-day, inventors and scientists, engineers and technologists have with ever in-

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A member of the Manitoba Institute since 1931, Mr. A. E. Green served for some years with the City Auditor of Winnipeg, whom he left to join the Auditor General's Department during the war. In 1945 he became a member of the Ontario Institute and is now engaged in internal auditing for the British-American Oil Co. in Toronto.

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creasing momentum made it possible to produce almost everything the human being desires in abundance. This, of course, is particularly so on the North American continent. The problem of distribution remains. One of the greatest methods ever invented of assisting in providing all the citizens of a country with goods and services which are common to all is the much maligned "income tax". I believe it was Stuart Chase, an outstanding American economist and writer, who, incidentally, is a certified public accountant in Boston, as his father was before him, who said that income tax is one of the greatest social inventions of all time. About June 20th each year, I am sure every chartered accountant in Canada has expressed himself in thoughts and words which would refute Mr. Chase. Nevertheless, I think we must agree that, properly applied, it is probably the fairest and most equitable method of taxation yet devised.

As public accountants, we are constantly confronted with income tax problems and the accounting profession in Canada has prospered exceedingly since 1917 when the *Income War Tax Act* was introduced. Canadian auditors, particularly during the period when the T.2-Questionnaire was called for, while appointed by the shareholders were, nevertheless, in a very direct manner also reporting and

expressing an opinion on the financial statements of the company to a Minister of the Government. This Minister, through our democratic method of government, represents in actuality the public, ourselves. It has become an almost accepted practice on the part of some business men to attempt to avoid paying their proper share of income taxes by various means. This places grave responsibilities upon the auditor. If the public accountant, when offering advice in this regard, remembers that his duty, in the long run, is to the public, there can be no question of his attitude in such matters and the client will respect him for it, probably not at the time but later, when he reads of cases involving prosecution which have some similarity to his own.

#### Private or Public Companies

In reporting upon the financial affairs of companies, the auditor must know whether or not the company is a private or a public one. If it is a public company, or a company having outstanding bonds, debentures or mortgages upon the properties, or a floating charge on the assets, etc., his responsibilities widen considerably.

There is an English case — *Pendlebury's Ltd. v. Ellis Green & Co.*, 1936 — involving the auditor's duty and liability in the instance of a private company where all the shares and debentures were held by the directors. There was a cash defalcation, and the auditor was able to prove that he had pointed out a lack of proper bookkeeping system and internal check on cash sales to the directors on prior occasions. The judge said:

The function of an auditor is to protect the shareholders, but one must have regard to the constitution of the particular company. There is a world of difference between a company which has a large body of shareholders and a company which has three shareholders, all of

whom happen to be sole directors and sole debenture-holders.

Companies whose capital structure consists of various types of stock, usually preferred and common, present still another problem as, in a sense, the auditor is acting as a referee in measuring the earnings of such a company. This is especially so in "bad" times, when often the earnings are sufficient to pay the preferred shareholders' dividend but not sufficient for any payment to the common shareholders.

#### Economic Conditions

The economic conditions of a country must be studied by the auditor and he must be constantly on his guard against the "doctoring" of the accounts to suit conditions. In good times, and especially in periods of high taxation, the management of companies is constantly on the lookout for various methods of "building up reserves" by such means as rapid depreciation of fixed assets, more than normal repairs, undervaluing of inventories, etc. While these devices are laudable in a sense, nevertheless their use does not make for consistent accounting methods nor accurate financial statements, least of all for a dependable indication of earnings. In depressions, the reverse situation very often applies and management strives by every means at its disposal to present a more optimistic financial situation than in fact exists. As the public accountant never knows for what purposes the financial statements upon which he has reported may be used in later years, his duty is to see to it that his remarks are so drafted as to stand the test of time.

#### Public Utilities

It is usually considered to-day that large public organizations such as hydro-electric power, gas and transportation companies have a rather special liability to the public, the users of the power, gas



or transportation. The auditor of such companies, while reporting to the shareholders, nevertheless is fully aware that his report will often be published in the daily newspapers and financial magazines. He must be prepared to substantiate his opinion at any time as these companies derive their revenue from franchises or rights awarded to them by provincial or local government bodies, which, once again, are the public.

Companies whose product is derived from the monopolist control of natural resources which the public must have, and at a reasonable price in order to live or maintain our standard of living, are constantly up for review by public bodies. Auditors of such companies assume special responsibilities apart from their normal duty to the shareholders.

We might mention too the large type of public institutions such as banks, life insurance companies, loan and savings associations, trust and loan organizations, in which the public invests or places its funds. While the Dominion Government in Canada exercises a certain measure of control over these companies, nevertheless the public places great significance upon the auditor's report on the financial affairs of this type of company. It is difficult to estimate the damage, hardship and suffering that would result if the auditor of such concerns should be wrong in his summary of the financial condition, not to mention the economic upheaval which might ensue from loss of confidence throughout the nation in such institutions. We need hardly mention that the auditor in particular and auditors generally would become the subject of public ridicule and the loss of prestige would be immeasurable.

#### Special Assignments

Auditors assume special responsibilities when they undertake special assignments. It might be appropriate here to mention a few of these.

**Prospectus Certificates:** Lord Plender once expressed the opinion that no class of accountant's certificate had greater publicity than the prospectus certificate, or was wider in its influence and appeal. He said further:

In the case of prospectus certificates the accountant is solely responsible for the manner in which they are framed; they are his entire creation and his sense of responsibility should prevent him from signing a certificate whose terms, whilst technically correct and sufficient, may nevertheless be presented in such a manner as to render the true results obscure and lend themselves to wrong construction and inferences. It is his duty to exercise all necessary care and caution to prevent possible misunderstanding, and whilst endeavouring to comply with the reasonable wishes of his client the accountant should remember that his first concern—which is not inconsistent with the client's true interests—must be for the public.

The *Companies Acts* of the Dominion and the various Provinces now include provisions for the prospectus, and a report by the auditors on the profits or losses for a stipulated period prior to the issue of the prospectus, as well as on a balance sheet at a specified date. As an example of the auditors' responsibilities in this connection reference is made to Parts VIII, IX and X of the *Securities Act*, 1947 of the Province of Ontario, where prospectus requirements with regard to securities of a mining company, an industrial company and an investment company are set forth. Each section refers to a balance-sheet which must be approved by two directors and accompanied by a report of the auditors of the company, who shall be persons acceptable to the Commission. I believe that this last clause — "who shall be persons acceptable to the Commission" — was a fairly recent amendment, as the Commission places great significance upon the

character and integrity of the auditor or auditors.

Part XIII of the Act, which deals with offences and penalties, indicates that:

Every person, including any officer, director, official or employee of a company, who is knowingly responsible for the furnishing of false information in any report, statement, return, balance sheet or other document required to be filed or furnished under this Act or the regulations shall be liable to a penalty of not more than \$2,000.00 or to imprisonment for a term not exceeding one year, or both.

It is quite evident that this provision would include the company's auditor.

#### Securities Exchange Commission

Somewhat similar circumstances prevail insofar as the auditor is concerned when reporting on financial statements which are to be filed with the United States Securities and Exchange Commission. Specific rules have been issued by the S.E.C. regarding accountants' certificates. It requires that the auditor's report or "certificate", as it is often referred to, be a frank and clear statement to the public. Under circumstances such as these, while the auditor accepts a responsibility to the shareholders, stockholders or directors, as the case may be, in the usual course of his duties he is answerable to a great many more people when the financial statements are required to be filed with the Securities and Exchange Commission.

There was considerable opposition to the *Securities Act* at its inception by investment bankers who strove to have the "teeth taken out of it". Particularly they objected to the production of financial statements in regulated form. John M. Hancock, of Lehman Bros., thought the unregulated annual report to the stockholders was good enough and pictured the S.E.C. as "confusing of intelligent but academic theorists and impossibilists

— monkish, mental gymnasts, striving foolishly in a necessarily imperfect world for absolute perfection". No doubt we have all thought as much after preparing one or two S.E.C. statements with the required numerous detailed schedules.

Jerome N. Frank, then chairman of the S.E.C., in replying to Mr. Hancock, said, in part:

The truth is that the major function of the S.E.C. laws, and the S.E.C. is conservative, is to aid the conservation of our American profit system under our democratic form of government.

That public accountants have had a major share in the practical workings of so great an institution whose sole duty is to provide accurate information for the public is indeed a tribute to the profession.

In Release No. 3277, Accounting Series, Release No. 64 of the Securities and Exchange Commission dated 15 March, 1948,<sup>1</sup> there is a report of the investigation by the Commission in the matter of Drayer-Hanson Incorporated, under sec. 8(e) of the *Securities Act*, 1933, which might be of interest as it is of recent date:

The investigation was to determine whether or not a registration statement filed with the Commission under the Act by Drayer-Hanson Inc. in respect of a proposed public offering of 80,529 shares of its Class "A" stock contained untrue statements of material fact or omitted to state material facts necessary not to make the facts disclosed in the registration statement misleading. The investigation disclosed that the registration statement did contain misstatements and omissions.

We are not concerned with the misstatements relative to the product, but we are all interested in the findings that the financial statements of the predecessor partnership as of 30th April, 1946,

<sup>1</sup>See also *Journal of Accountancy*, May, 1948, page 435.



certified by independent public accountants, were deficient in that the net worth of the predecessor partnership and its earnings, computed on a corporate basis, were substantially overstated. The auditors evidently mentioned in their report that "they had no reason to believe that the inventories as set forth in the accompanying statements are unfairly stated". An error was made of approximately \$97,000 with regard to work-in-process and fabricated parts. I am uncertain as to the powers of the Commission, but it appears from notes to this release that as part of the scheme of rehabilitating the company the public accountants have agreed to pay the company \$87,500.

#### Cost Investigation

Cost investigations were frequently undertaken during and after the recent war in order to arrive at an equitable basis for settlement of war contracts. This special type of auditing required a considerable knowledge of cost accounting, and, while the auditor usually reported to his client, he was fully aware that his report would be placed before officials of the Dominion Government to be used as a basis for renegotiation or settlement. Here again, whilst attempting to present his client's case in the best possible light, the auditor was bound to disclose all material facts regardless of their import. To do otherwise would have brought discredit not only to his own good name but to the profession as a whole.

There are, of course, bankers, investors, creditors and, of recent date, labour unions who may be vitally interested in the opinion which the auditor has expressed with regard to financial statements. It would seem that the auditor must size up each assignment individually and attempt to ascertain who may ultimately be interested in his report. The purchasers of a business, who are probably about to pay out a substantial

sum of money, may use the auditor's opinion for many purposes. Likewise, the seller of a business is most concerned with the auditor's remarks. These types of special assignments throw grave responsibilities on the auditor.

#### Special Services Rendered

There are a number of special services which the auditor renders to his clients apart from the strict verification of financial statements. Acting as an adviser in the case of companies which are in financial difficulties is one. If these happen to be public companies his decisions may affect the fortunes of a large number of people, and, while he could not be held liable in a court of law for a poor decision, the public reaction would be damaging to him, his firm and the profession, if it became public knowledge that his advice was sought.

Accountants of late have become in a sense advocates in pleading a client's case before a judge, board, commission, etc. Much sound work has been done in this connection relative to settlement of claims for standard profits before the Board of Referees. The presentation of evidence before the courts in the establishment of public utility rates has become an accepted part of the public accountants' work and from time to time they are asked to act as advisers to the Dominion and Provincial governments. These types of work affect the general public in a most direct manner.

We have discussed at fair length some aspects of the auditor's moral responsibility to the client and to the public and the consequences which may ensue to him and his fellows should he not be competent in the performance of his duties. In addition to loss of prestige and probable loss of clients and fees, however, he may be sued for damages for negligence in the performance of his duties as auditor.

### Legal Decisions

There are a number of well-known British, American and Canadian legal cases where the auditor was held negligent and was sued by the shareholders, stockholders or directors. These cases uphold the principle of law that any person who intimates that he is skilled in any trade or profession and who is negligent in the performance of what he undertakes becomes responsible in damages for such failure.

There is the occasional case such as the *Royal Mail Steam Packet Co.* case. (Lord Kysant and H. J. Moreland, chartered accountant and former auditor of the company) which is of a more serious nature, in which the auditor was charged in Britain under the Larceny Act with aiding and abetting the Chairman, Lord Kysant, in the issuance of false annual reports with intent to deceive shareholders. The auditor in this case was found not guilty, although Lord Kysant was found guilty.

This is not the proper place to discuss auditors' legal cases in detail. The point to remember, however, in most of these cases is that the auditor was sued or charged under various Acts by the shareholders. There appears to be only one outstanding case on record where anyone other than the shareholders has laid a charge against the auditor. This is the famous *Ultramares* case, tried in the State of New York, in which the decision of the Court of Appeals of the State was delivered by Chief Justice Cardozo.

#### The Ultramares Case

Fred Stern & Co. Inc., rubber merchants, engaged auditors in January, 1924 to prepare and certify a balance sheet of the company as at 31st December, 1923. It was well known to the auditors that the balance sheet would be used for credit and financing purposes and for this reason thirty-two copies of the state-

ment were supplied. The auditors' "certificate", as it was then usually referred to rather than "opinion", read:

Certificate of Auditors: We have examined the accounts of Fred Stern & Co., Inc. for the year ending December 31st, 1923 and hereby certify that the annexed balance sheet is in accordance therewith and with the information and explanations given us. We further certify that, subject to provision for federal taxes on income, the said statement, in our opinion, presents a true and correct view of the financial condition of Fred Stern & Co. Inc., as at December 31st, 1923.

The balance sheet indicated that the company was financially sound. Actually it was insolvent. The books had been falsified and if a proper audit had been performed, suspicions would have been aroused and the whole matter disclosed.

The Ultramares Corporation, on the strength of the balance sheet, certified by the auditors, advanced money to Fred Stern & Co. Inc., which company was declared bankrupt in January, 1925 Ultramares lost \$187,576.32. A court action was brought against the auditors by Ultramares Corporation, — a third party, mark you, — firstly for negligence and secondly for fraud.

The case moved through several courts and finally rested in the Court of Appeals. Evidently the auditors had made no attempt to verify after closing entries increasing sales and accounts receivable by \$706,843.07. Nor did they enquire about a receivable in the accounts payable ledger of \$113,119.60. Both items were false. Large errors were discovered in the inventory and the same assets were pledged to different banks at the same time. The latter facts were known to the auditors, but they did not become suspicious.

The Court of Appeals dismissed the action for negligence against the audi-

tors, although the jury and the Appellate Division of the Supreme Court had decided against them. The Chief Justice pointed out, however, that "accountants are not to be relieved from liability if their audit has been so negligently performed as to justify a finding that they had no genuine belief in its adequacy, for that again is fraud. But if less than this is proved, if there has been neither reckless misstatement nor insincere profession of opinion, but only honest blunder, the ensuing liability for negligence is restricted to those having joint knowledge of contract".

In dealing with the action for fraud, the trial judge had dismissed the charge; this was affirmed by the Appellate Division but the Court of Appeals reversed the decisions of both lower courts and granted Ultramares Corporation a new trial. The case ended at this juncture, as the parties settled the matter quietly out of court, which is significant.

As Gerald Jephcott, F.C.A., pointed out in an article in Volume 21, page 92 of *The Canadian Chartered Accountant*, summarizing this important case:

- (1) An accountant cannot take refuge behind his contract alone but owes some duty to unknown persons who may depend upon the work which he performs.
- (2) An accountant's certificate or opinion must mean just what it says and knowledge must mean real knowledge and not mere belief.
- (3) An accountant may be guilty of fraud if he does his work carelessly

and indifferently, without thought or consideration of unknown persons, who may rely upon the financial statements and contents of his covering certificate.

### Conclusion

By and large, public accountants and auditors have fallen into a relatively insignificant amount of trouble. In commenting on this fact, when addressing the Institute of Chartered Accountants of Manitoba some years ago, E. K. Williams, K.C., and now Chief Justice of the Province, concluded that it was probably because the chartered accountant had no sex appeal. Possibly this subject could be the topic for a paper at some later date.

Finally, I offer the remarks of the managing editor of *Saturday Night* who said in reply to a letter in which the question was asked — "Is the auditor's prime responsibility to the company's shareholders or the public?":

As a financial editor who has scanned many financial statements, I have always felt that auditing by a chartered accountant and the statement by that chartered accountant at the foot of the report, certainly involved and implied some degree of responsibility to the public. It seems to me that the duty of the chartered accountant is to establish the truth, that this is his 'prime responsibility' and in fact his only responsibility.

From this editor's remarks and the various comments previously referred to, it is my conclusion that the auditor's prime responsibility is to the public.

## A Recent Book

**The Tax Dodgers**, by Elmer L. Irey; published by Greenberg, U.S.A.; distributed in Canada by Ambassador Books, Ltd., Toronto, Pp. 288, \$3.75.

Mr. Elmer L. Irey, former chief of the Enforcement Branch of the U.S. Treasury, has, in collaboration with William J. Slocum, set out in this most interesting and entertaining book the story of the Treasury Department's efforts to track down income tax evaders and of how (as the cover jacket puts it) "they backed into racket busting". It is the tale of the success of painstaking accounting investigations and the tracing of financial transactions which successfully brought to book murderers, kidnappers, hijackers, confidence men and other criminal law-breakers, whom the usual agencies of law enforcement seemed unable to touch. It covers a variety of cases ranging from bootlegging to gambling and to political gangdom in the United States.

It is a frank story of success and of failure, of reflections that hindsight proved that simple thinking if acted upon might save months and years of detailed and involved investigation. The following 3 paragraphs at the opening of the chapter of the Lindbergh case set the basis for this comment:

Three times a soft-voiced Treasury agent named Arthur P. Madden managed to get the floor during 3 smoky meetings where Colonel Charles A. Lindbergh sat surrounded by police officials from New Jersey and New York City and a coterie of private detectives and gangsters. Three times they all listened as Madden quietly told them where to find a piece of paper that would solve the crime of the century — the kidnapping and murder of Charles Augustus Lindbergh, Jr.

All the meetings were in New York City and in the 30 seconds it took Mad-

den to outline his plan he found time to point out that the piece of paper lay only half an hour away. Each time Madden spoke his idea was greeted enthusiastically as sane, sound and obviously worthy of immediate investigation. But it was so obvious, so simple, and everybody was so terribly busy that it was lost in the shuffle and as a result it took 30 months to catch Bruno Richard Hauptmann. It should have taken 6 weeks—8 at the most.

That was just one of the fantastic frustrations in the manhunt for Hauptmann. A manhunt that was filled with frustrations, sadistic humans, suicides, murders, spiritualists, hoodlums, and a weird assortment of odd executives who wandered in and out like clowns in a funeral procession. Red herrings seemed to fall from the skies for two and a half years, and the long arm of coincidence swept from Hopewell, N.J., to such exotic places as Uzsok, Czechoslovakia, and the underworld of Calcutta.

Eighteen pages later, we learn how a quick check along the lines of the suggestion proved beyond doubt that the man who had passed one of the ransom notes at a gasoline station was the man who wrote the ransom note. Painstaking checking at the start of the investigation would have pointed the finger at Hauptmann in a matter of weeks.

To those who enjoy the reading of true crime detective stories, verbatim reports of trials and the summing up by counsel and judges, as this reviewer does, this book lays the basis for a quiet week-end. The only criticism, and it is a friendly one, is that, from an accountant's point of view, it could have gone into considerably more detail and lengthened the story of each case dealt with. Perhaps that would have destroyed its public appeal.

R.F.B.T.

# Canada's Central Bank

By Graham Towers

(Governor of the Bank of Canada)

The Bank of Canada opened its doors in 1935, the Industrial Development Bank in 1944. What have they done for the Canadian economy?

I HAVE often been asked to give a brief and simple explanation of why we have a central bank such as the Bank of Canada and to describe its activities. This is a difficult — perhaps an impossible — task because a discussion of banking in general and central banking in particular is bound to contain a certain amount of technical material which is not readily understood unless one has some familiarity with the subject.

## Its Establishment

The first point that comes to my mind about the Bank of Canada is the situation which ultimately led to its establishment. Canada is not a country which moves with undue haste in matters of this kind and one has to go back to 1914 to understand why the Bank of Canada Act was passed in 1934. Until the First World War, the Dominion Government note issue had to be backed 100% by gold except for a comparatively small fiduciary issue. Any increase in the issue of legal tender, therefore, required an addition to our gold reserves. At the beginning of the First World War it was recognized that an increase in legal tender was both essential and inevitable if war activities were to be financed. Do-

minion Notes would be required both for public circulation and to meet the need for larger cash reserves of the chartered banks as their business expanded. However, with a war on and the United Kingdom off the gold standard, it was most unlikely that Canada would obtain the additional gold backing for any considerable increase in the Dominion Note issue. In these circumstances, Parliament passed the *Finance Act* in 1914. This measure authorized the Government to lend Dominion Notes to the banks against the deposit of appropriate security. The *Finance Act* of 1914 was in fact a recognition that at least some of the facilities of a central bank were needed in Canada.

Shortly after the end of the First World War some Canadian bankers, notably the late Mr. E. L. Pease, felt that while the *Finance Act* had rendered invaluable assistance during the War, it left something to be desired as a permanent piece of financial machinery. They proposed that the *Finance Act* should be replaced by a central bank. However, they found few supporters and many opponents. In 1923 the *Finance Act* was reconstituted on a peace time basis and

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Address to The Institute of Chartered Accountants of Ontario,  
April 21st, 1949, Toronto, Ontario

in the years following up to 1929 its facilities were used on a large scale and at the peak of the 'boom' in 1929 borrowings by banks under the *Finance Act* reached the amount of \$111 millions. Then came the crash and the deficiencies of the *Finance Act* became obvious. The events that followed made the banks most anxious to reduce their borrowings under the *Finance Act* and in the process their cash reserves were brought down to an uncomfortably low level. This decline in their liquidity put pressure on the banks to reduce their loans and investments. Efforts by banks and others to sell caused market yields on high grade securities to rise considerably, tending to discourage new capital investment at a time when the opposite result was desirable. To some extent also, banks' own impaired liquidity made it impossible for them to look after their customers' normal credit requirements.

Since the period of depression following 1929 was an almost world-wide catastrophe, it is inconceivable that any domestic policy — monetary or other — could have shielded us completely. But it became apparent that in addition to the unfavourable non-monetary factors at work, the banking situation to which I have just referred was contributing a further and undesirable deflationary pressure. After the *pros* and *cons* of the matter had been aired before a Royal Commission in 1933, the Commission reported in favour of a central bank and Parliament passed the *Bank of Canada Act* in 1934. In March 1935 we opened our doors.

### Its Objectives

Fourteen years have passed since that time and I believe it would be difficult to find another period of like length in our history, when Canadians had to cope with as important and varied national problems as those which we have faced since 1935. Within this relatively brief

space of time we emerged from the worst economic depression the world has ever seen, survived 5 years of all-out warfare and then went on to a post-war period of full employment in which the market for our products, generally speaking, has been greater than our ability to supply.

Before describing the Bank of Canada's operations during this period I think it would be desirable for me to refer briefly to the broad objectives which the Bank of Canada was expected to seek, and which were outlined in the Preamble of the Act of Incorporation, reading as follows:

It is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion.

You will notice that throughout the Preamble it was emphasized that the objectives of the Bank were to be 'general' or 'national' in their scope. This emphasis reflected the fact that monetary action by the central bank would not be appropriate for dealing with localized problems. The Bank was to concern itself with providing the broad financial background which would encourage a high and sound *overall* level of economic activity.

It is also important to note that the Preamble limited the objectives of the Bank to the extent that they might 'be possible within the scope of monetary action'. This recognized that variations in the general level of 'production, trade, prices and employment' were importantly influenced by factors other than monetary action by the central bank and that there might be circumstances in which the best



monetary policy would not be sufficient to counteract other influences. While the Bank's primary responsibilities are in the monetary field it is, of course, necessary for us to be in touch with every phase of Canadian affairs which has a bearing on economic activity.

The story of the Bank of Canada's operations since 1935 can conveniently be divided into three periods — pre-war — war — and post-war.

### Pre-War Period

The pre-war period of our operations began after recovery from the worst effects of the depression had started, but unemployment was still very evident and in the circumstances an 'easy money' policy was appropriate. For that reason the Bank of Canada carried on 'open market' purchases of Government securities which increased the cash reserves of the chartered banks and maintained their liquidity somewhat above the normal level so that they would have an incentive to expand credit in the form of loans or security purchases, as opportunities were presented. The overall result of monetary action in these years was quite substantial as is indicated by the fact that total Canadian bank deposits and note circulation in August 1939 were about 14% higher than in the former peak year of 1929.

One of the more apparent results of easier monetary conditions was the decline which took place in the yields on high-grade securities. For example, the rate on long-term government bonds declined from an average of more than 5% in 1932 to approximately 3% in the years 1936-39. Many borrowers — both public and private — took advantage of the lower level of interest rates to refund obligations incurred at higher rates and so reduce their fixed charges.

Ideally, it would have been desirable for the reduced level of interest rates to

have stimulated a substantial further increase in the rate of new capital investment which in 1939 was still only about one-half the 1929 level. In that event our favourable balance of payments on current account in those years would have been used to finance larger imports of capital goods. However, depression psychology had taken such a firm hold that even easy money conditions and lower interest rates failed to stimulate an adequate volume of new investments. Under the circumstances, our favourable trade balance was largely used for the repatriation of debt previously held abroad.

However, a very considerable improvement in economic conditions did take place in the period 1935-1939. The gross value of production which fell from \$6 billions in 1929 to only \$3½ billions in 1933, because of the decline in both physical production and prices, had recovered to \$5.6 billions by 1939. But for the continued low level of prices for farm products because of conditions in foreign markets, our gross value of production in 1939 would have considerably exceeded the 1929 level.

Although the rise in economic activity to which I have referred was large enough to restore the 1929 physical volume of production by 1939 it was not enough to produce full employment due to the increase in the number and productivity of our population of working age and therefore we entered the war period still with a considerable amount of unemployment.

### The War Period

The outbreak of war made it evident that there would be more than sufficient demands to absorb all our resources and it was only in the early stage when some additional monetary expansion was deliberately undertaken.

During the remainder of the war per-

iod the government endeavoured to meet as much as possible of its expenditures by taxation. However, as the scale of war expenditure increased, taxation — even when pushed to what seemed to be the practical limits — provided only about half the total amount of funds required.

There was no alternative but to finance the remaining part of the government's fiscal needs by borrowing — which meant an increase in the general public's holdings of liquid assets. When borrowing took the form of purchases of government securities by banks, the increase in liquid assets of the public was in the form of currency and bank deposits. When the borrowing was by means of selling government securities to the public, the increase in public holdings of such securities represented an increase in their liquid assets. An effort was made to persuade the public to invest as much as possible of its liquid assets in government securities rather than currency or bank deposits, largely because it was more likely that the public would associate the increase in its holdings of government securities and the great need for saving during the war period.

Government borrowing from the public during the war years was at rates of interest which, broadly speaking, were approximately the same as the pre-war interest rate structure of the years 1936-39. Neither Canada nor any other major country felt that the effectiveness of the intensive war-time savings programme would be increased by higher interest rates on government bonds. Indeed, an upward trend in interest rates might well have seriously impaired the voluntary savings programme because the public would have been unwilling to buy bonds if it was likely that bond prices were going to drop.

In the wartime circumstances which I have just described the best we could do

was to try and see that credit expansion did not exceed, in any material way, the amount required for the essential purpose of winning the war. The Bank of Canada tried to keep the banks' cash reserve position as near as possible to what was regarded as 'normal' so that they would not be encouraged to make any unnecessary credit expansion because of 'excess' cash reserves. The fact that the average ratio of cash reserves to Canadian deposits rose from about 10½% before the war to 11½% in the latter war years was not so much indicative of excess cash reserves, as of the fact that under war conditions banks' ideas about their normal cash ratio had increased somewhat.

Two other considerations were also very important in restraining unnecessary credit expansion during the war years. Direct government controls of one kind and another prevented the public from undertaking non-essential activities of most kinds, so that there was much less pressure to borrow funds from banks for such purposes than would otherwise have been the case. Finally, I believe that the banks themselves had a clear understanding of the kinds of transactions which were not in the general interest under wartime conditions and that they exercised a good deal of common sense in avoiding undesirable or speculative lending. The fact that there was no appreciable overall increase in banks' loans and non-government investments during the war period, in spite of the large increase in economic activity and prices, is I believe fairly good evidence that non-essential credit expansion was, in practice, kept to a minimum.

#### Post-War Period

Following the last Victory Loan in the fall of 1945 a strong market for government bonds developed and the interest yield on the longest-dated issue declined from 3% to about 2.6% per annum. This trend was not due to central bank action

but rather to support from non-banking investors. United States government bond prices also rose during this period, the long-term issues yield declining from about  $2\frac{1}{2}\%$  to just over  $2\%$  per annum.

After this flurry of strength the bond market returned to the position where the general public was on balance an appreciable net seller of bonds. There was nothing unexpected about this situation in view of the large increase in public bond holdings during the war and the extent of deferred expenditures and investments of various kinds. In addition the rate of such public bond selling showed a definite downward trend and there was no particular evidence that it was encouraged because the public felt that interest rates were too low.

In the final quarter of 1946 and during 1947 the monetary situation was improved because the government had an overall cash surplus of substantial proportions available to reduce the total liquid assets held by the public. In part, this surplus resulted from the reduced scale of war and demobilization expenditure; in part, it was due to the loss of foreign exchange reserves. The government applied the major portion of this cash surplus to redeem bank-held government securities. As a result of the government surplus, total liquid assets of the general public declined somewhat in 1947 even though there was a large increase in chartered bank loans and non-government securities.

Towards the end of 1947 the picture changed. The United States bond market entered a period of weakness with certain psychological reactions on Canadian investors, and the rate of Canadian net public bond selling which had almost vanished by mid-1947 turned sharply upwards. At the same time it became evident that the rate of new capital invest-

ment was going to be materially increased — even though with full employment of labour and materials this could only result in driving up dollar costs rather than physical quantities of such investment.

Market forces were permitted to bring about an increase in the rate of interest on government bonds in January and February 1948. The yield on the longest-dated issues rose from about  $2.6\%$  to just under  $3\%$  per annum — representing a decline in price of about  $4\frac{1}{2}$  points. At that time the Bank made a public statement to the effect that this increase in interest rates did not appear inappropriate at a time of very large capital investment, but that the Bank was not in favour of a drastic increase in interest rates which might prevent essential forms of capital investment which Canada needed.

Also in February 1948 Bank of Canada suggested to chartered banks that it was, in general, inappropriate to finance business capital expenditures by means of bank credit at a time when the expressed intentions of business to increase materially the rate of such spending could only serve to drive up dollar costs still farther. An exception was made in the case of small concerns which would not be able to do public financing. In February of this year the Bank announced that it had withdrawn this suggestion to the banks because the abnormal pressures which had given rise to it had abated somewhat.

During 1948 the government's overall cash surplus available to reduce the total liquid assets held by the public, was small as compared with 1947. The main factor in the change in the government's cash position between 1947 and 1948 was the development of a substantial export balance in Canada's international transactions during 1948 which was used to rebuild the exchange reserve and made

it necessary for the government to advance to the Foreign Exchange Control Board the Canadian dollars needed to finance this increase in reserves.

The increase in chartered bank loans and non-government investments during 1948, though much less than in 1947, was still considerable and somewhat larger in amount than the government's over-all cash surplus. The net result, therefore, was that in 1948 there was an increase in the general public's aggregate holdings of liquid assets, which came very close to offsetting the reduction which had taken place during 1947.

As I have already mentioned, much of the war-time increase in the general public's holding of liquid assets was the result of fiscal necessity and not necessary on economic grounds. Probably therefore some decrease in the aggregate of such liquid assets after the war period, if feasible, would not have been inappropriate. However, this could have taken place in only two ways. First, government might have maintained larger overall cash surpluses than have in fact been received. I do not know whether more strenuous efforts in this field would have met with general public support. Secondly, there would have had to be less increase in chartered bank loans and non-government investments in the post-war period. On this point I think it was inevitable that there should have been a substantial increase in bank loans in the circumstances of 1947 and 1948. There was an increase in the physical volume of business in those two years and a strong upward influence from other countries on our price level; both these factors involved an increase in the current financing requirements of business, which at the same time was making large expenditures for capital replacement and expansion.

When a country is waging an all-out war, in practice monetary action cannot

be wholly conceived in terms of its effect on 'production, trade, prices and employment' (to quote from the Preamble to the *Bank of Canada Act*) but in effect monetary expansion becomes the residual instrument of fiscal policy. After several years of all-out war when monetary expansion of necessity has exceeded economic requirements and when the general public (and governments as well) have accumulated urgent backlogs for consumption and capital goods, it is not likely to be feasible to reduce the public's total liquid asset holdings, to a major extent. To a large degree the remedy for the monetary situation inherited at the end of such a war period, must be to encourage as large as possible an increase in the physical volume of production and trade. In that event upward pressure on the general price level is minimized.

It is not yet certain that the world is ready to settle down to a normal, peacetime existence which would avoid the extremes of economic behaviour that tend to limit the effective scope for monetary action. But in view of the importance and variety of the national problems we have faced in the first 14 years of the Bank of Canada's existence, I believe that properly-timed action by the central bank can continue to make an appreciable contribution towards the economic welfare of Canada.

#### Industrial Development Bank

In one important respect the scope of the Bank of Canada's activities has been increased beyond the type of monetary action envisaged at the time of its establishment. I refer, of course, to the setting up of the Industrial Development Bank in 1944 as a wholly-owned subsidiary of the Bank of Canada. I am sure that many of you have come in contact directly or indirectly with IDB operations during the course of the past four and a half years.

Chartered accountants have a better opportunity than most people to appreciate the financial problems faced by small and medium-sized industrial concerns seeking to become established or to expand the scale of their activities. It is usually possible for such firms to obtain reasonable working capital assistance through chartered bank loans but very difficult for them to obtain longer-term money to finance plant and equipment because they are too small to go to the market for new public security issues. It is this type of situation which the Industrial Development Bank was designed to meet.

When IDB was first established some doubts were expressed as to whether the 'gap' in our financial machinery to which I have referred was significant enough to warrant a new lending institution. In its first 4 years of operations IDB dealt with 1,640 applications for credit, of which 535 were withdrawn by the applicants because their requirements had been found elsewhere or for other reasons; 519 refused by the Bank and 586 authorized for a total amount of \$39,027,624. The 586 credits which the Industrial Development Bank authorized during its first 4 years of operations, have been widely distributed. A classification of the Bank's loans shows that almost every type of industrial enterprise is represented and we have extended credit in every province of Canada.

#### Employment of Specialists

We have found it necessary to include a considerable number of specialists on the staff of Industrial Development Bank. In addition to officers with banking experience, there are engineers, chartered accountants, lawyers and men with a background in insurance matters. I am sure you realize that the smaller business concerns are usually not equipped to pro-

vide these services. For example, we have very often found it necessary to give advice to clients regarding the maintenance of proper books and audits in order that they themselves as well as IDB will know whether the business is actually making progress or not.

For reasons of this sort, the expense of carrying on the type of lending in which IDB is engaged tend to be rather heavy and doubts were expressed in 1944 as to whether IDB could be financially successful in this type of financing. On other occasions I have said that it takes at least 10 years' operating experience under varying economic conditions to get a fair picture of the financial results of an institution such as IDB. In the 4 year period actual losses have amounted to only \$34,340.12 and reserves amounting to \$1,083,612.09 have been accumulated. There are undoubtedly accounts on the Bank's books on which additional losses will be suffered, but there is nothing discouraging about our experience to date.

I might mention one other problem which we have experienced in connection with IDB. That is the matter of making our facilities known to potential borrowers without engaging in the kind of advertising or promotion which would be out of place for a residual lending institution of this kind. There have been occasions when chartered accountants have suggested to their clients that IDB might offer a solution to their financial problems. I think it would be helpful to all concerned if industrial firms requiring medium — or long-term — financing were at least made aware of the existence of IDB.

#### A Period of Growth

Earlier in my remarks I suggested that the Bank of Canada had lived its life during a period distinguished by unpre-



cedented problems. It has also been a period of great development. Between the years 1939 and 1944 the volume of production — and I underline the word 'volume' — increased about 40% although the increase in the employed civilian labour force was only about 15%. Effective organization, continuity of production and last but not least, heavy investment in new plant and machinery all contributed to this remarkable result during such a short period of time. It is this ability to increase our productive capacity which, taken in conjunction with other measures, has proved such an effective barrier to the more extreme type of inflation with which so many other countries have been plagued. We were able to supply our overseas partners in the war with \$11,000 millions worth of goods and services, and after the war, in the years 1946-48, to extend credit and relief to other countries to the tune of \$1,600 millions. Over and above these activities, we have since 1945 been engaged upon the greatest peace-time programme of capital development which has ever taken place in Canada. However, all this has not taken place at the cost of lowering the standard of living of our people. On the contrary, the increase in our total volume of production has supplied a larger amount of goods and services for domestic consumption with the result that our average standard of living has shown an appreciable increase not only during the past decade but also as compared with the last period of peace-time prosperity and high employment in the years 1928-1929.

#### The Future

These are some of the good features of Canadian economic history in recent times. I think we do well to remind ourselves of such a remarkable record of performance, so that we do not become discouraged by the problems which un-

doubtedly lie ahead. One cannot forget that our export trade normally accounts for about 20/25% of our total production, nor that the war has greatly changed for the worse the situation of some of our major and traditional customers abroad. So far, as the record shows, this has not interfered with our having a high level of prosperity in Canada. To a large extent, this has been because the countries concerned have received large credits, and, more recently, ERP aid, which has enabled them to maintain their dollar imports at a high level. But they have been urged to make plans which will greatly reduce, if not eliminate, their dollar deficits by 1952. If such a balance in their dollar trade is chiefly attained by an increase in their exports to dollar countries, well and good. But if they rely in large measure on reducing their imports from dollar areas, or on bilateral trade deals among themselves, the outlook for Canadian export trade would not be favourable. Already there have been instances of developments along these lines having an adverse effect on certain Canadian exports.

It is not for me to predict — indeed it would be impossible for anyone to predict — just what the outcome of this situation will be. A forecaster in 1945 might well have felt entitled to take a gloomy view of Canadian prospects in the years immediately following the war, having in mind the vast destruction and dislocation which had taken place over a large part of the world. Events would have falsified such prophecies. It might be equally wrong today to forecast a period of effortless and untroubled prosperity. With so much of the world in trouble, North America can hardly expect to avoid some toil and sweat, and perhaps a few tears. But I do feel, so far as Canada is concerned, that the high quality of our population, and the character of our na-



tural resources — so much needed by the rest of the world, including our neighbours to the south — provide a sound basis for an optimistic estimate of Can-

ada's prospects over the years, unless one subscribes to the view, which I most certainly do not, that common sense has vanished from the international scene.

## OBITUARY

### The Late Lt.-Col. H. J. Webb

The Institute of Chartered Accountants of Quebec announces with deep regret the death of Lt.-Col. H. J. Webb on February 12th, 1949, in his sixty-ninth year.

Born at Iffley, England, Lt.-Col. Webb was educated in schools in the City of Oxford, and then studied accountancy. His studies completed, he became an associate member of the Institute of Chartered Accountants in England and Wales in 1904 and in 1910 came to Canada and joined the Quebec Institute. He became widely known through the paper industry with which he was identified since 1921, when he was made comptroller of the Riordan Company, and subse-

quently acted in a similar capacity for the Canadian International Paper Company. He was president of Canadian and Foreign Investments Limited, president of Bathurst Electric and Water Power Company, and was also connected with the Cascapedia Manufacturing and Trading Company and the Cascapedia Booming Company as well as being a director of Lake Roman Mines.

Lt.-Col. Webb was an officer with the Victoria Rifles of Canada and retired as a lieutenant-colonel in 1933. He was a member of the St. James's Club, the Royal Montreal Golf Club, the Royal Automobile Club, also the Metropolitan Club, New York.

To his widow, the members of the Quebec Institute extend their sincere sympathy.

## Current Reading

By R. F. Bruce Taylor, F.C.A.

### Accelerated Depreciation

**T**HE CONTROLLER, April 1949, reproduced the following paragraphs describing the depreciation policy of United States Steel Corporation as set out in the *U.S. Steel Quarterly* by the Chairman of the Board. They should be of interest to our readers.

In its accounts for 1947, United States Steel reflected in the total wear and exhaustion for the year an amount of \$26,300,000 in addition to the normal depreciation based on original cost of its facilities. This added amount, which represented 30% of the normal depreciation, was determined partly through experienced cost increases and partly through study of construction cost index numbers. Although it was materially less than the experienced cost increase in replacing worn-out facilities, it was a step toward stating total wear and exhaustion in an amount which would recover in current dollars of diminished buying power the same purchasing power as the original expenditure.

This principle was continued during the first three quarters of 1948. In view of the continued increase in the cost of goods and facilities during 1948, the additional charge for wear and exhaustion was advanced, effective as of January 1, 1948, to 60% of the depreciation based upon original cost, because the 30% initially adopted was not sufficient to cover the true cost of property currently consumed.

In the last issue of the *Quarterly*, it was stated that, in view of the position taken by the American Institute of Accountants and the discussions between the Corporation and the Securities and Exchange Commission, further study was being made in an effort to agree upon principles satisfactory to the Commission for determining and reflecting additional wear and exhaustion cost.

United States Steel believes that the

principle which it adopted in 1947, and continued in 1948, is a proper recording of the wear and exhaustion of its facilities in terms of current dollars as distinguished from the dollars which it originally expended for those facilities. However, in view of the disagreement existing among accountants, both public and private, and the stated position of the American Institute of Accountants, which is supported by the Securities and Exchange Commission, that the only accepted accounting principle for determining depreciation is that which is related to the actual number of dollars spent for facilities, regardless of when or of what buying power, United States Steel has adopted a method of accelerated depreciation on cost instead of one based on purchasing power recovery. This method is made retroactive to January 1, 1947. The amount of the accelerated depreciation for the year 1948 is \$55,314,736, including a deficiency of \$2,675,094 in the amount reported in 1947 as depreciation added to cover replacement cost. Such accelerated depreciation is not presently deductible for Federal income tax purposes.

The accelerated depreciation is applicable to the cost of postwar facilities in the first few years of their lives, when the economic usefulness is greatest. The amount thereof is related to the excess of current operating rate over United States Steel's long-term peacetime average rate of 70% of capacity. The annual accelerated amount is 10% of the cost of facilities in the year in which the expenditures are made and 10% in the succeeding year, except that this amount is reduced ratably as the operating rate may drop, no acceleration being made at 70% or lower operations. The accelerated depreciation is in addition to the normal depreciation on such facilities but the total depreciation over their expected lives will not exceed the cost of the facilities.

# Taxation, Auditing and Ethics

By C. H. Kohler, F.C.A.

**The accountant is something more than an advocate of his clients' interest**

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## Opening Remarks

**T**HE TITLE of this article may puzzle you. It may sound irrelevant to put three different subjects on one line. Had it been entitled the 'Ethics of auditing and taxation' you would have guessed what to expect: you would have expected a dry disquisition into the morality of taxation and auditing, an inquiry having as its subject not the purpose of taxation and auditing but their inherent goodness or evil. We are not going that way, however. Our path is more practical and of more immediate professional interest. We are concerned with the accountant's ethics when he confronts problems arising out of his professional work on taxation and auditing. What is it right for him to do on this or that occasion? Should he qualify his report? Should he disclose all the facts to the Inspector?

## Is There a Moral Conflict?

You may ask, why should there be a moral conflict? An accountant's first duty is towards his client and if he has secondary duties towards others, is there not a law or practice to guide him? The question is pertinent and two-pronged. First, is the accountant's allegiance only to his client or is it to a wider

public? Secondly, are there laws so precise that confusion is the penalty of misunderstanding? Let us take each part of the question separately.

I think that an accountant is more concerned with the whole aspect of truth than with one of its facets and that his training and practice are directed towards one end—the ascertaining and presenting of correct figures and information. If this rather generalized statement is broadly true then it follows that an accountant is as much a public servant as a private retainer.

## The Auditor's Report

Take the auditor's report to the members of a limited company. Therein the auditor makes certain assertions and tenders certain opinions. It will be instructive if we list these in numerical order. He asserts:

- (1) That he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit.
- (2) That the balance sheet and profit and loss account are in agreement with the books of account.

While he gives it as his opinion:

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- (1) That proper books of account have been kept by the company so far as appears from his examination of the books.
- (2) That to the best of his information and according to the explanations given to him, the accounts give the information required by the Companies Act, 1948, in the manner so required and give a true and fair view — (a) in the balance sheet of the state of the company's affairs and, (b) in the profit and loss account of the profit (or loss) for the period.

I think you will agree with me that this report is not a privileged document meant only for the private reading of the members. That may be one reason—perhaps the most important—for its preparation, but it will in fact be read and noted by a wider public. That surely is why our report entails such responsibility: we are stating that in our opinion a certain account gives a true and fair view of a company's affairs. What I wish to emphasize has been ably expressed by another and better-known accountant. I refer to Mr. Campbell's address to chartered accountants at this year's Oxford summer course (see *The Accountant*, August 7, 1948). He said:

"The question is sometimes raised as to whom the presentation is to be fair, and the answer seems implicit in the Act that the scales are to be fairly held between the interests of the company as a whole and the interests of all who are concerned with its accounts, the shareholders and creditors at the date of the accounts, potential members of either class, the directors, and, in exceptional cases, the economic interest of the country. The former conception of an auditor as a watchdog of the shareholders, only barking on their behalf, has been gradually weakening

for years and cannot survive the implications of the Act."

I applaud every word of this statement and would only add to the list of those who are concerned with the accounts the Inland Revenue, for they are as much entitled to a true and fair account as the members or any other interested party.

Next time your principal signs the auditors' report do not be impatient if he pauses or cross-examines your notes: at this stage the principal feels like an author appending his signature to a book and not knowing where or by whom it will be read. Perhaps this simile is imperfect, for whereas the author has himself done all the work he subscribes, with an audit, he subscribes to work he has only partly done. Or put another way, it may seem to you that the major share of the labour, if not of the fruit, has fallen to you rather than to him. Well, if that is so then you have an additional incentive to pass your examinations.

### The Word 'Fair'

I have left for consideration the second and more vexed point; namely whether the law governing the conduct and responsibility of an audit is explicit. Do not sharpen your pencils: I am not going to recite the rights and duties of auditors; my object is a narrower one, namely to find where the guidance of the law ends and practice and conscience start. I think the stumbling-block is the word 'fair': you will recollect that in the revised report the auditor must give as his opinion that the accounts show a true and fair view of the state of the company's affairs and of its profit and loss. To vouch for the truth is difficult but to judge what is fair is sometimes impossible. We see a girl passing down the street. To say that she is a girl is the truth but to judge whether she is fair, why, that, gentlemen, is beyond our pre-

tensions! And yet this example is not too exaggerated, for judgments as difficult, if not so embarrassing, may be demanded of us.

Let us take an example. Stock as valued by the directors may show in the balance sheet as £5,000. What have we done to verify the figure and what guidance do we receive from the Act? The Act gives no direct help: we read through the instructions in the Eighth Schedule but find no mention of stock; we are not even told to value it at the lower of cost price or market price. Under the Companies' Act, 1929, we need not have worried ourselves too much: if the stock was described 'as valued by the directors' and we had a certificate to that effect then it was probably true, and certainly in accordance with the books. But is the value 'fair'? The obligation is on us to certify that, in our opinion, the balance sheet gives a true and fair view of the state of the company's affairs. It is assumed that we have imposed the customary audit checks. We have cast the stock sheets, tested the extensions, compared descriptions, quantities and prices with last year's sheets and compared the prices of several materials with those shown on current invoices. Now for our first imaginary problem. Let me, at the very beginning, emphasise the difficulty. It is one where the directors wish to postpone tax by writing down the value of stock and to that end exaggerate the depreciation in a particular material. Let us suppose that the company makes toy prams and that these are covered with plastic hoods: you would then expect to find hoods of varying sizes and prices among the materials. Perhaps you find ten to fifteen varieties—small or moderate in value—but in accord with recent invoices. You turn the page and there at the top find 'sundry hoods, say, £200'. The qualifying word 'say' is repulsive to a well-trained article clerk:

he becomes suspicious and makes inquiries. He is told that the hoods were bought in several lots some six or nine months ago: a few were bought with Bank of England notes from a man with padded shoulders but most were imported from Spain. Further, the purchases were made in haste because it was feared they might become scarce or unprocureable; in fact, the supply became more plentiful, cheaper and better so that the warehouse is crowded with hoods alleged to be out of date and, in the opinion of the directors, the estimated value of £200 is probably excessive.

#### Valuation

We must first decide on the value of this hood material. We know one thing and that is its original cost of, say, £600: that is a certainty among much speculation. At the risk of confusing you, and by stepping aside from the main problem, I should like to discuss an aspect of valuation. I think it would be logical though unorthodox to value this material at cost even though the replacement value of similar material might be cheaper. I am here deliberately differentiating between raw material used in production and finished goods ready for market: my interpolation relates only to raw materials. I suggest that unless the finished product is sold at a loss there is no reason for depreciating the value of unused raw materials. Let me illustrate this statement. I am an apple pie baker and sell for sixpence pies that cost me threepence to make—a penny for the apple, a penny for other materials and a penny for cooking and overheads: net cost threepence and net profit threepence. Suppose that when my day ends and I prepare my account that I have a dozen apples on the table. I say these should be valued at a penny each even though the shop next door sells them at only a half-penny each: providing the sale price of a pie remains at threepence or more I am bound to re-

cover my outlay; why, therefore, should I depreciate one of the components? If the apples are to go into pies and the pies are to be sold at a profit then why make provision for a loss? However, I warned you that this was a diversion and having, I hope, made my point, let us turn from pies to hoods.

The directors allege that the price of hoods has fallen and that the value for balance sheet purposes is not cost but market. Very well, let us admit their assertion and ask for proof. Can the directors show us price lists or invoices of similar materials at a reduced price? The reply is 'no': part of their argument is that the hoods are outmoded and no longer obtainable: material of the same weight can be purchased without difficulty and at a price cheaper than that paid for the Spanish goods but the identical hoods are not now procurable or in demand. Therefore the market value is not ascertainable and the directors have used their judgment and trade knowledge in estimating its worth at, say, £200.

#### A Measure of Depreciation

You listen with patience and some sympathy to these persuasive assertions: you are perhaps convinced that the directors speak the truth and that the hoods are of no use for their trade but will be sold in bulk or possibly used for another purpose and that to include this material among the other stock at a value of £200 would be to present a true and fair view of the company's affairs. You therefore accept a measure of depreciation—in this instance, say £400—and search for words to express this in the detailed profit and loss account. You suggest as a narrative

'Provision for estimated depreciation in value of foreign hoods, £400',

and having to your mind phrased a long story so concisely, you wait for applause. Instead, your suggestion is received with evasive coughs, partly smothered protests and facial contortions, all indicating that

you have made a tactless statement. You catch at threads of conversation all leading to a certain 'he', such as 'he would never allow it', or 'he would not stand for it', or, 'they would never get past him'. The younger members of this audience may wish me to interpret these cryptic comments. I will do so. 'They' is short for the auditors: 'him' or 'he' refers to His Majesty's Inspector of Taxes and 'it' to the proposed depreciation of stock. What the directors mean, though they hesitate to express their thoughts fully and lucidly, is this: Are the auditors capable of persuading the Revenue to accept as an allowable deduction from assessable profits the item of £400 described in the accounts as provision for estimated depreciation in value of foreign hoods? I need not emphasize that in this imaginary example the directors are full of apprehension. They know well that the depreciation cannot be wholly confirmed and that the loss, though in large measure expected, is future rather than present. It is not a realised loss in the sense that the hoods have been sold or discarded within the accounting period.

#### The Heart of the Subject

Gentlemen, I have brought you into the very heart of my subject. Auditing, taxation and ethics are all involved in this problem. As an auditor you must prepare an account that shows, in your opinion, a true and fair view of the state of the company's affairs, as an accountant you have a dual and sometimes conflicting obligation in that you should help your client while also assisting the Inland Revenue, at the very least by disclosing all the ingredients of the accounts which call for consideration.

Let us return to the example, analyse the alternative courses of action and discuss their effects. The stock could all be valued at cost but that surely would be deceptive—for consider a prospective purchaser: he looks at the balance sheet



and assumes it to be a true and fair picture of the company's assets. By retaining cost values without comment you have not indicated that a substantial quantity of hoods is out of date and may have to be sold at a loss approaching £400. Is it fair to publish such an account? Might it deceive not only a purchaser but a member contemplating the acquisition of further shares; and what about the estate duty office or assessors for a fire insurance claim? We return to one of my opening paragraphs where in I stressed that a balance sheet is not a confidential document for the private reading of the members: it is looked at and acted upon by a much wider audience.

Suppose you follow the directors' wishes and leave their written-down value undisturbed. You accept the statement that the hoods are out-moded if not useless, and that the directors are the best and only competent judges of value. You therefore adopt their figures and show on the balance sheet 'stock as valued by the directors'. Perhaps there is a slight doubt in your mind, but then have you not discarded responsibility by showing the basis of valuation? You have not described the valuation as your own, or that of an independent expert or even as at cost, or at market, or at the lower of cost or market; you have simply and honestly labelled the stock as valued by the directors. Does not that put the public on inquiry and absolve you from responsibility? I think not. The words of our report cannot be too often repeated. The auditor must still be satisfied that, to the best of his information and according to the explanations given to him, the accounts give a true and fair view of the state of the company's affairs and of the profit or loss for the period. Always you must first address yourself to that searching test and answer it to your satisfaction.

It may be that the depreciation is exactly £400, so that the directors' valuation accurately expresses the market value of the stock. Could one not then leave well enough alone. I fear not. I think we must be satisfied that the profit and loss account is fairly drawn. If the depreciation is concealed, then the gross profit ratio is disturbed and in this instance distorted.

### Relaxing with Apple Pies

Let us return for relaxation to apple pies. You may remember the figures cited some minutes ago, namely, that it costs threepence to make a pie selling for sixpence. Now for a simple trading account. On Monday I make ten pies and sell the lot. The cost will be thirty pence—sales sixty pence and gross profit thirty pence, or 50 per cent of sales. On Tuesday I am more industrious: I bake twenty pies and sell ten of them; the other ten are unfortunately spoiled by wasps and unsaleable. We can construct the trading account together. Cost of making twenty pies will be sixty pence or five shillings; proceeds from sale of ten pies at sixpence each will also be sixty pence or five shillings. Stock on hand is wasp-nibbled and worth no pence. Profit nil; loss nil. Let us pause and cool our minds. Does the account truly and fairly mirror the transactions? I think a cost consultant, or for that matter a second-year articled clerk, would say no. We have telescoped two transactions into one. In fact, ten pies have been sold at a gross profit of thirty pence and another ten pies, costing thirty pence, have been wasted; we have therefore a gross trading profit of thirty pence against which to set a provision for loss through wasps amounting to thirty pence, leaving neither profit nor loss. But the second account tells the full story while the first account was so abbreviated and condensed that it was misleading.

I thing you will now understand why the depreciation of the stock of hoods should be recorded and displayed. If the depreciation is not singled out and shown, then the gross trading profit will be inexplicably diminished by £400 and the ratio of gross profit to sales mislead all who read the detailed account. That is why I think the unusual depreciation should be shown in the profit and loss account.

#### In the Judgment Seat

If you insist on showing the depreciation, then the Inspector of Taxes will note it and probably question it as a deductible expense, and that would trouble your clients. So you see the conflict. You are in the judgment seat and it is for you to gather the evidence, consider it, and with your knowledge of auditing and taxation make a decision. But the accountant is not placed completely independently for he is directly employed by one of the contestants to persuade, if not confront, an opponent, and his fees are influenced by the result of the contest. A victory for his patron may bring him substantial prize money, but defeat or unwillingness to fight may end his engagement. Well, why worry? To be rid of an awkward client is no great loss. If that is your attitude it shows your ignorance; true, to lose a fee of five guineas is perhaps a small matter, but what if the culprit is your most important client; what if his fee amounts to 250 guineas and your gross takings only touch a thousand? Let me prick you a little deeper: what if you live only by the fruits of your work and others are dependent on you; you have perhaps a family or, even more embarrassing, an elderly clerk. Strictly to apply justice is then no carefree task.

You may say that an accountant's place is in the body of the Court and that his function is to advocate his client's cause;

it is for the Commissioners of Inland Revenue to decide whether this or that is a proper expense, and for us to marshal arguments in our client's favour. The Inspector is the Commissioner's servant and we the servant of our client; there is no equity in income-tax law, but decisions are made by reference to Finance Acts. We are not makers or interpreters of the law, and it would be arrogant to claim such a distinction. We are qualified by study and practice to prepare accounts and put before the Revenue a computation of assessable profits; it is implied that we understand the law and that we apply it rightly, and it is expected that where the law does not fully illuminate a subject then we select cases and propound arguments that shall put the matter in a favourable light. To compare our responsibilities with those of a Judge is to exaggerate; if legal similes are required, then our function can be likened to that of a solicitor.

#### The Accountant's Two Parts

The accountant does in fact act two parts. In his office as auditor he must be judicial; he will listen to submissions, but if they are in conflict with the law or his duty, then he must obey the law. In his capacity as a negotiator he approaches the advocate but differs from him in extended duties. The advocate only brings forward facts and arguments that favour his client; he knows that his opponent will emphasize the other side. Compare this with the negotiation of an income-tax assessment. The subject of inquiry is the profits earned by the trader and the evidence is a true account and full relevant explanations. I think the accountant's duties extend beyond those of an advocate in the production of this evidence. You will appreciate that the Inspector can only ask questions; he cannot normally himself go behind the books and examine invoices or inspect stock. He relies on the accountant firstly

to produce an accurate account and, secondly, to submit all facts affecting the accounts, and therein rests the dilemma, for figures or narrative often tell only part of a story and there is no one other than the accountant to divulge the other part.

Let us take a simple example. You draw up a profit and loss account and include among the expenses one with the general but embracing description of 'miscellaneous expenditure, £25'. This may comprise three distinguishable outgoings: office teas £10; donation to the Home for Tired Horses, £10; and wedding present to the accountant's artied clerk, £5. You submit the accounts to the Inspector, but is that enough? You could do three things and I shall not here argue which of the three is right. Firstly, you could send him the accounts and offer to answer his inquiries. Secondly, you could analyse the expenditure, claiming all or some of the outgoings as permissible deductions but not offering any comment or explanation; and lastly, you could set out the three sub-headings and append to each a short descriptive narrative and so substantiate whatever you claim. I am not suggesting that one of these approaches is jesuitical or that another is desirable: to do that would be dogmatic. I do, however, emphasise that judgment and responsibility are here involved.

### An Old-Age Pensioner

Now for another example. You know that there is an obligation on an employer to deduct income-tax from all emoluments assessable to income-tax under Schedule E. There are exceptions to this statement, but speaking generally, it is the law. Again speaking generally, I would add that not all employers apply the provisions precisely. How often one is told that some casual hand is an old-age pensioner and so exempt from tax; evidently the employer makes little inquiry of

the man as to other means or other employment; the old man's assurances are accepted and no one asks or tells the Revenue about the engagement. I say 'old man', though age is evidently deceptive: I only hope that I may look as youthful and act as vigorously when the time comes to tender my coupons for cheap baccy! But suspicion is not certainty, and to challenge the transaction is to accuse either the client or the old man of dishonesty, and is this necessary? The payment is correctly described as wages, and we are assured that there is no obligation to subject these wages to tax deductions: we can warn the client that if the old man made false or ignorant statements then they, or in the last resort the client himself, may be asked for restitution, but usually these warnings trouble no one. This simple example again emphasises our dilemma. Our privileged office gives us access to all the private records of a business and we are glad of this opportunity to exercise our skill: we conscientiously do our work and in its course discover some misdemeanour. What are we to do? Are we to divulge our findings and so harm our client and probably lose work, or are we to keep quiet? I am not in this instance coupling the query with the foregoing example: it is a general question, and to obtain an answer we must apply it to particular facts. Nevertheless, in different forms and with varying emphasis such questions often perplex us.

### Directors' Expenses Allowances

One last example. Let us discuss directors' expenses allowances. You will have read that periodical drawings of round sums are now to be treated as remuneration and subjected to the provisions of P.A.Y.E. This would affect a director accustomed to draw, say, £50 a month for expenses; before the passing of the Finance Act, 1948, he might have received the money gross, made the neces-

sary disbursements, and possibly retained the balance as pocket money. On the other hand, it would have been the responsibility of the company—or, more accurately, its professional accountant—to persuade the Inspector that the whole of the expenses should be charged against the company's assessable profits. The task of the accountant is now lightened. The company will normally be allowed to charge the full expense, but it will be for the director to prove that he spent the money wholly, exclusively and necessarily in performing the duties of the office.

This is not usually to the liking of the directors. It puts them to the bother of recording all the money they spend and may impose tax on the portion that they retain or the part they cannot bring within the restrictive phraseology of Rule 9, for the Inspector will be more critical of expenditure than the fellow-directors and ask for some proof that the money has been wholly, exclusively and necessarily spent. This is not the only disadvantage: you will remember that the Companies Act, 1948, Section 196, directs that the accounts shall disclose any sums paid to directors for so-called expenses, though in fact as remuneration. The exact words read:

'any sums paid by way of expenses allowance in so far as those sums are charged to United Kingdom income-tax.'

This may be a form of publicity that the directors prefer to avoid, so to overcome the tax and disclosure difficulties they ask the company not for an expense allowance of, say, £50 a month, but for irregular odd sums of, say, £50 0s. 1d. every three to five weeks. The demand is supported by a letter or voucher describing the money, not as an allowance but as exact reimbursement of sundry trade expenses including entertaining, travelling and tips. If the auditors de-

mand that the board authorise the payment, then the required resolution will be passed. What is the auditor to do? The articles permit the board to be repaid expenditure incurred on behalf of the company; the board meets and authorises the expenditure; the outgoing is correctly recorded in the books and witnessed by a form of receipted invoice.

#### A Request for Supporting Evidence

If you ask one of these directors for supporting evidence he will laugh loudly, put one hand on your shoulder and explain that you cannot get a receipt for a double Scotch, that railway tickets are handed in to the collector, and that it is bad form to ask a waiter for written acknowledgment of a tip. The hand is then raised off your shoulder and the comment put to you: 'Nothing much we can do about it, old boy, what?' And the only truthful answer is 'No'. You may not be convinced but to probe further would be to suspect the directors of fraud, and why should you take such an unloving view: it may well be that the drawings *are* in order. It would be stretching our responsibility as auditors to expect us to put such a matter to the Inspector as meriting inquiry, while from the viewpoint of the Companies Act we are absolved, as the director, rightly or wrongly, has not paid tax on the drawings.

I think that I have given sufficient examples to show the moral perplexities that confront an accountant; you will have met other problems yourselves and know that our office is no sinecure. True, the ultimate responsibility of decision may not as yet rest with you, but by your selection of queries and by formulating opinions thereon you will be influencing the client, your principal, and also your own character and professional approach.

Let me recapitulate. I have argued that the report attached to an account is addressed not only to the client but

to a much wider public, and that the compilation of a true and fair account is therefore a great responsibility. The auditor cannot tell when, where, or by whom the account and the report will be read, and he must, therefore, be sure that he can withstand any challenge. I have also said that in tax negotiations the accountant is more than a special pleader. The Revenue rely on him to bring forward accurate figures and full relevant facts: *he must play the cards as well as he can but he must put them all on the table*. Next we must address ourselves to another question: what can we turn to for help and instruction in carrying out our responsibilities? I think the superficial answer is easy, namely, to the Companies Act, 1948, the Finance Acts, the general body of decided cases, and the precedents of professional practice; in short, to the subjects included in your examination syllabus. The moral difficulty is not usually that of determining the law but of adapting it, stretching it, or even avoiding it for the benefit of the client. I hope I have illustrated these difficulties and emphasised our peculiar problem, namely, that of preserving integrity while pleasing our client. Let there be no illusions, there are times when adherence to law and the best practice will make enemies and lose business; there is nothing purely academic about taxation, auditing and ethics.

### Motives

Before concluding I will touch on motives. Why do the affairs of some clients occasion us so much worry? I suppose that we must put the blame on Eve: had she not listened to the serpent our work would have been simpler though perhaps duller. We cannot deny or overlook evil: while I believe with George Fox that there is that of God in every man I am equally convinced of the contrary, or, to quote William Blake:

'I in my Selfhood am that Satan,  
I am that Evil one.'

On the other hand, let us preserve proportion and, above all, charity. The complexity or even inhumanity of to-day's industry, the scarcity of materials and labour, and the artificiality of taxation all encourage breaches of the law.

### Illustration of Inhumanity

Just then I spoke of to-day's industry as inhuman. I will try to illustrate this by an example. When we sit down to breakfast, the butter and the marmalade lie before us. We take a bit of each but not too much. This restraint is not from fastidiousness or lack of appetite but rather the presence of our family or friends. We do not wish to deprive mother of her fair share, and when it comes to father, why, he is loud in asserting his rights! So we have two natural and visible checks each exercised by our near neighbour. Now compare this with an industry using some material in short supply—for instance, wool.

This wool is allocated to certain industries by the Board of Trade so that often output is restricted by the amount of the allocation. Such an arrangement may be unavoidable and fairly devised for the community as a whole, but the energetic producer will see it only as a hindrance to be avoided. He may therefore buy wool without authority at whatever price he can get it. He will ease his conscience by two considerations. Firstly, that all his competitors may do it, and secondly, that unless he buys wool the factory will be on short production and some men will be out of work. What he says is probably true and shows that he is motivated by two desires: for himself greed or survival; towards his men loyalty and sympathy. But the point I want to make is that there are no visible moral checks; there is no mother to please or father to obey. The trader hears that some extra wool is for sale, but he does



not by refusing it directly please another, nor by buying excessively anger anyone. Each trading unit is independent, and only concerned with itself: further, it is difficult for the trader to see who in fact does suffer by these doubtful transactions. In this example the wool surplus may originate from faulty measuring or from inefficient paper work, but it might in other instances have been the fruit of fraud, robbery and violence. Buying on the black market may therefore encourage crimes beside showing disrespect for the law and indifference to fair sharing. So when you are next shown a voucher on unheaded paper inscribed in pencil, "To wool, £500", you will know something about its origin, even if you do not know how an auditor should deal with it.

Gentlemen, I am nearing the end of my talk. Nowhere have I told you what to do or what not to do. I have deliberately refrained from passing judgments or listing instructions. Each problem is separate and unique, so that a general law might carry your consent but nevertheless be of small use in practical application. All that I can do is to offer a few suggestions based on experience.

#### Suggestions

First, I suggest that you discuss your difficulty with others, thereby you will be taught to see the problem from several sides, and this will help you towards a realistic, all-round judgment. Next I think it wise sometimes to ask help from an older man, say a senior or one of the partners. It is not so much his greater experience or riper judgment that you want, though obviously these are of value, but rather his help in approaching and persuading a difficult client. Can I put it this way: none of us likes a younger brother to point out our faults or omissions; we listen to such reprimands with greater attention if they are delivered to us by a contemporary. In fact, we are all a little like the Japanese in that we

fear to lose face. Third, use judgment in yielding small points. It is a curious streak in our make-up that we count victories by number instead of by weight. For example, you go to the Inspector of Taxes to settle a long-drawn-out negotiation, and he grants, say, three small concessions which save your client £20, but on the main issue involving, say, £2,000, he remains obstinate. Nevertheless, you return almost satisfied and boast to your client and to your colleagues that on three separate occasions you scored victories; on the result of the real battle you are less emphatic. So do not be too greedy or pig-headed; be firm in the centre while willing to yield on the out-field. But I do not want to imply that the relationship should be antagonistic: we must never forget that we are servants, though at times our allegiance must be to a higher authority, so use persuasion rather than threats. This leads to my last suggestion, namely, to be wise as serpents. If your client is intent on, say, under-valuing his stock and thereby avoiding or, at least, deferring income-tax, look around for arguments that will deter him instead of pointing to the law or reciting back-duty penalties. If you tell him and convince him that under-valuation may affect the price he will get for the sale of his business or for the settlement of a fire claim, you will find him more responsive. That, gentlemen, is all that I have to say. I hope that I have not discouraged you by emphasising moral difficulties. On the whole you will, I think, find your clients understanding and co-operative. Sometimes, however, they are not aware of our duties and responsibilities, and then a frank disclosure may win their sympathy. And remember that you are not alone in upholding high standards. We are a young profession but we have a tradition of accuracy and, above all, of integrity, and that can only be handed on if we acknowledge it and strive to maintain it.



# Surplus

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## A suggestion for precision in nomenclature

ACCORDING to standard dictionaries a surplus is defined as "that which remains over and above what has been taken or used, excess" or "what remains to make up a whole". It is generally conceded that the first of these meanings is the one ordinarily thought of when this word is used. While it is often used in this sense when discussing financial affairs and in financial statements, it is more commonly used by accountants as a technical term with a meaning approaching "what remains to make up the whole". As a technical term it is used to describe the balance of profits unappropriated or undistributed, the net of gains less losses on the disposal of long term assets, the amount by which the fixed assets have been written up on the basis of an appraisal, the amount of undistributed profits set aside as the result of the redemption of preferred shares under specified circumstances, in addition to a number of other items. It is little wonder that the reader of financial statements who has little or no knowledge of accounting often reaches erroneous conclusions as to what is meant by the term "surplus".

Strictly speaking, a company can be said to have a surplus only when the equity of the shareholders has increased,

as a result of operations or transactions which have resulted in profits or gains, above the amount they invested in the company. It often happens, however, that shareholders pay to the company an amount in excess of the par or stated value of the shares, and the law requires that the par or stated value be shown separately. This premium is frequently designated as "surplus" and, in addition to meeting the requirements of the law, such segregation provides shareholders with additional information as to the amount of their equity which can be repaid to them without the necessity of complying with the provisions of the law as to alteration or reduction of share capital. In addition, sec. 12 of the *Dominion Companies Act* provides that not more than 25% of the consideration received for no par value shares may be set aside as "distributable surplus", and sec. 61 requires that the surplus set aside as a result of the redemption of preferred shares shall be designated as a "capital surplus". There may also be instances in which shareholders donate cash or other assets to the company and reasonableness would indicate that the amount of such contributions should be segregated from the amount paid in respect of the par or stated value of shares is-

sued. The accounting treatment accorded the foregoing transactions is designed to record the amount of the investment by the shareholders in the company rather than to reflect the market or realizable value of the shareholders' equity.

Many accountants think that the term "surplus" is one that should be avoided wherever possible. However, it is in general use as a technical term and the committee on accounting and auditing research has considered, in connection with its work on the revision of the *Manual of Accounting Terminology for Canadian Practice*, the meaning which should be attributed to the term. The committee is in agreement with the post-war planning committee and suggests that surplus should be classified according to its source, that is whether derived from shareholders or from operations. While there may be circumstances in which a division of surplus as between the distributable and undistributable portions is desirable, the requirements of the law and business conditions are such that, with the exception of "distributable surplus" under sec. 12 of the *Dominion Companies Act*, no clear cut distinction between the two is possible.

It is suggested that much of the confusion surrounding the term "surplus", as used in financial statements, would be eliminated if it were used only in the following senses:

#### Contributed Surplus

The sum of the premiums received by the company in respect of shares issued, the undistributed portion of any amount set aside as "distributable surplus" within the provisions of sec. 12 of the *Dominion Companies Act*, the surplus resulting from the redemption, cancellation or alteration of the company's share capital, including any "capital surplus" arising under the provisions of sec. 61 of the *Dominion Companies Act*, the net of gains less losses arising from transactions between the company and its share-

holders in the shares of the company and the cash or other assets donated to the company by its shareholders.

#### Capital Surplus

The sum of the amounts set aside from earned surplus in connection with the redemption of preferred shares of the company in accordance with the provisions of sec. 61 of the *Dominion Companies Act*.

#### Distributable Surplus

The undistributed portion of the consideration received for no par value shares set aside in accordance with the provisions of sec. 12 of the *Dominion Companies Act*.

#### Earned Surplus

The sum of the profits from operations and other gains, including the gains on disposal of fixed assets, less losses and dividends declared (other than dividends declared specifically out of "contributed surplus") and amounts transferred to "contributed surplus" in connection with the redemption or alteration of the company's share capital.

The foregoing recommendations depart from certain accepted practices in some respects. In the case of "distributable surplus" it is suggested that the use of the term be confined to those instances in which this so-called surplus amount has arisen because of the operation of sec. 12 of the Act. The post-war planning committee of the Dominion Association of Chartered Accountants has recommended the elimination of this provision from the Act, but until such a change becomes law, accounts will have to be arranged to provide for this item. In the case of "capital surplus" the restriction of the term to those amounts arising in connection with the redemption of preferred shares in accordance with sec. 61 of the Act will exclude therefrom gains on the disposal of capital or fixed assets, profits on the re-sale of donated shares in the company and extraordinary gains. "Earned surplus" will include a number of items sometimes formerly classified as

"capital surplus", particularly the net gains on the disposal of capital or fixed assets.

In some instances the book value accorded assets of a company is increased as the result of an appraisal of the assets. The offsetting credit is often classified as an "appraisal surplus" or a "revaluation surplus". Since this amount records an increase in the value accorded to the assets which is not earned, it should not be described as a surplus item. This amount, in fact, represents the difference between the previously written down book value of the assets and the estimated realizable or depreciated replacement value and would be more appropriately described by some term such as "unrealized appreciation in fixed assets".

The committee on accounting and auditing research is endeavouring in its work on the revision of the *Manual of Accounting Terminology* not only to define the terms in common use in Canadian practice, but at the same time to arrive at new definitions which will assist in the development of accounting as a more useful tool, not only to business but to the understanding of business by the general public. The committee earnestly solicits any comments you might care to make in connection with the foregoing suggestions to make "surplus" a better understood term, as well as those you might care to offer on any other aspect of the revision of the terminology manual.

#### Assets and Liabilities

Upon being asked by a bank manager to submit a statement of his assets and liabilities in order to procure a loan, a customer submitted the following information:

Cash on hand .....	\$ 200
Bonds at bank .....	2,400
Accounts receivable .....	3,924
Merchandise .....	9,828
Wife and daughter .....	500
War savings certificates .....	90
Loan from bank .....	1,450
Accounts payable .....	2,878

Upon investigation it was found that the 'wife and daughter' represented bonds owned by the wife and daughter.

(With thanks to Mr. M. Howard C.A., Winnipeg)

# Professional Notes

## NEWFOUNDLAND

Mr. A. C. Lloyd Hudson, C.A., announces the opening of an office for the practice of his profession at Reid Bldg., St. John's, Nfld.

## ONTARIO

N. Perlmutter & Co., Chartered Accountants, announce the removal of their offices to 4th Flr., 220 Bay St., Toronto 1, Ontario.

Henry Glover & Co., Chartered Accountants, announce the removal of their office to Suite 705, National Bldg., 347 Bay St., Toronto 1, Ont.

The 1948-49 Year Book listing of Mr. Thomas Gordon Dalglish, C.A., who has been engaged in practice for himself since January, 1948, should have been: Dalglish, Thomas Gordon† (1926), Rm. 1003, 62 Richmond St. W., Toronto, Ont. (Glasgow 1926)

Glendinning, Jarrett, Gray & Roberts, Chartered Accountants, Toronto, announce the admission into partnership of Mr. J. Clendon Reid, C.A.

## PRINCE EDWARD ISLAND

The Institute of Chartered Accountants of Prince Edward Island announces that the following candidates were granted supplements in the intermediate examinations, 1948: C. C. Hickey, A. C. MacLean, H. G. Williams. Those who passed in the primary examinations were: J. P. Campbell, H. A. Forsythe, C. E. Johnston, W. A. Robertson.

A meeting of the students of the Prince Edward Island Institute was held in Charlottetown on April 2, 1949 for the purpose of forming a Students' Association. Thirteen

students were present at the meeting. The following officers were elected: President—H. G. Williams; Vice-President—H. A. Forsythe; Secretary-Treasurer—A. J. Garrett. It was decided to hold meetings once a month and to arrange for lectures.

## QUEBEC

Convocation exercises of the Quebec Institute were held on March 10, in the Windsor Hotel, Montreal, for successful candidates in the final examinations held during November 1948. Over 75 of the 99 candidates who passed the final examinations received their certificates from Mr. T. V. Burke, president of the Institute, assisted by Mr. G. P. Keeping, honorary secretary-treasurer.

In the evening more than 500 members of the Institute attended the annual dinner in Windsor Hall at which the guest speaker was the Hon. Paul Beaulieu, M.L.A., C.A., Minister of Trade and Commerce of the Province of Quebec. He was introduced by Mr. Jean Valiquette, second vice-president, and thanked by Mr. A. Emile Beauvais, immediate past president. Medals and prizes were presented by the president to the winners.

Messrs. Marc Angers, B.A., C.A., and Godfrey Gourdeau, M.Com., C.A., announce the formation of a partnership under the firm name of Angers, Gourdeau & Co., Chartered Accountants, with offices at Rm. 412, 400 Charest Blvd., Quebec City.

Mr. Arthur D. Ruby, C.A., announces that Mr. Lewis J. Manolson, B.Com., C.A., has been admitted to partnership and that henceforth practice will be conducted under the firm name of Ruby & Manolson, Chartered Accountants, at 1117 St. Catherine St. W., Montreal.

# The Students' Department

J. E. Smyth, C.A., Editor

## NOTES AND COMMENTS

THOSE OF US who have taken part in security counts at banks will no doubt have thought at one time or another how ingenious man really is to crowd such enormous wealth into the same physical space as four or five copies of today's newspaper might occupy. Someone casually pushes a tray by containing \$10,000,000 in stocks and bonds. He is softly humming a tune from "Porgy and Bess" which we recognize as *I've got plenty o' nuthin'*. In the next 15 minutes we personally examine and check against a list still other securities valued at \$15,000,000. We are impressed.

The thing that used to occur to us on these occasions was that the same wealth expressed in any other form would be so much more spectacular — a Queen Mary, a skyscraper, a giant factory, or for the aesthetically-minded even, a bin of diamonds. We now realize, or think we do, that all this paper in the form of stock and bond certificates is not wealth in its own right at all. It is only *evidence* of the right or title to wealth. Would the country be any poorer if rats invaded a bank's vaults and chewed up all the bank's "paper" assets? With the same thought in mind we doubt if a person could be charged with arson under *The Criminal Code* for playfully touching a lighted match to the edge of a \$100,000 registered bond (though goodness knows what else he might be guilty of).

Paper seems to be no more than a necessary part of the process of converting one's wealth into cash. In the form of a negotiable instrument it carries a promise that can be transferred "for value"; in the form of a bond it is evidence of a claim against a borrower that can be sold on the bond market; in the form of a share certificate it is evidence of title to some fraction of the working assets of a business, inaccessible to their owners except through the medium of the stock exchange. In all cases it becomes possible to sell or "realize" the wealth by transferring the piece of paper that provides evidence of it.

Just as another example, a business man in immediate need of funds may draw drafts on his customers and either put them up as security for a bank loan or discount them at his bank. Thanks to the piece of paper he draws his drafts on, he does not have to wait until the term of credit expires and his customers pay him.

\* \* \*

WE HAVE been hearing quite a bit lately about a certain company reorganization. One of the things accomplished by this particular reorganization was to convert arrears of cumulative preferred dividends into new second preferred shares. The holders of the original preferred shares received a new second preferred share for a given number of dollars of arrears outstanding on their old shares, plus of course, new

first preferred shares to replace the original ones.

In this case, paper, in the form of share certificates, opened a path to rights which were otherwise of little value. There are few things quite as inaccessible as arrears of dividends on cumulative preferred stock. The arrears are not even a recognized liability of the company,

nor the shareholders creditors, until the directors actually declare dividends in respect of them. But once there is a reorganization, with a backlog of arrears converted into share certificates, then there is a means of realizing on the arrears by selling on the stock market the shares given for them.

## CORRESPONDENCE

*Winnipeg, Manitoba.*

Sir: I wish to draw attention to what I consider a radical departure from sound balance sheet presentation in the published solution to Question 5, Auditing II of the December 1947 Final Examination published in the January 1949 edition of *The Canadian Chartered Accountant*. The question at issue is the treatment of bond discount unamortized which is shown in the solution as a deduction from the par value of the bond liability of \$3,000,000.00.

This treatment is suggested by Professor R. G. H. Smalls in his *Accounting Principles and Practice* which is quoted by Dean J. H. Thompson in his review in the December 1948 issue as follows:

Too often bond discount is set out on the assets side of the balance sheet as a prepaid expense or deferred charge. It is neither of these; it is not an asset of any kind. It is an amount which the company has contracted to borrow but which it has not yet borrowed.

In the normal use of the term Deferred charge there is no necessary implication that such a charge constitutes an asset. It is meant to indicate simply the postponement

of a charge or expense which has been incurred so as to give effect to such expense in future income statements. In the case in question, if it is considered not desirable to show the \$60,000.00 bond discount unamortized as a deferred charge, a case might be presented for deducting it from Earned surplus. To deduct it from the face value of the bonds however is to directly understate the liability. The question as to whether or not the company has contracted to borrow an amount but has not yet borrowed it appears to me to be completely irrelevant. The fact remains that the company has contracted to repay the amount of \$3,000,000.00 and therefore the liability should be shown in that amount.

I would appreciate very much the comments of others on this point. I think it important, however, that the solutions to examination questions published in *The Students' Department* should be prepared according to generally accepted accounting principles in order to avoid confusion in the minds of students. Theoretic discussions and criticisms of current accounting practice, however sound, should not be presented in a way which might be construed by students as authoritative statements.

WILLIAM H. GRAY, C.A.



## SOLUTION TO LAST MONTH'S PUZZLE

Number the coins "1" to "12".

Legend:

= : Scale balances.

"H to": Left heavier than right.

"L to": Left lighter than right.

Weigh #1	Weigh #2	Weigh #3	
1, 2, 3, 4=5, 6, 7, 8			9, 10, 11, 12 contain false coin, 1 to 8 are true
	1, 2, 3=9, 10, 11		12 is false coin, 9, 10, 11 are true
		12 H to 9 12 L to 9	12 is heavy false coin 12 is light false coin
	1, 2, 3 H to 9, 10, 11		9, 10, 11 contain light false coin
		9 = 10 9 H to 10 9 L to 10	11 is light false coin 10 is light false coin 9 is light false coin
	1, 2, 3, L to 9, 10, 11		9, 10, 11 contain heavy false coin
		9 = 10 9 H to 10 9 L to 10	11 is heavy false coin 9 is heavy false coin 10 is heavy false coin
*1, 2, 3, 4 H to 5, 6, 7, 8			If 1, 2, 3, 4 contain false coin it is heavy or if 5, 6, 7, 8 contain false coin it is light
	1, 2, 7=3, 5, 9		4 may be false heavy coin or 6 or 8 may be false light coin
		6 = 8 6 H to 8 6 L to 8	4 is heavy false coin 8 is light false coin 6 is light false coin
	1, 2, 7 H to 3, 5, 9		1 or 2 may be false heavy coin or 5 may be false light coin
		1 = 2 1 H to 2 1 L to 2	5 is light false coin 1 is heavy false coin 2 is heavy false coin
	1, 2, 7 L to 3, 5, 9		3 may be false heavy coin or 7 may be false light coin
		3 = 9 3 H to 9	7 is light false coin 3 is heavy false coin

\* If weight is

1, 2, 3, 4 L to 5, 6, 7, 8—all conclusions are reversed for all weighings as a substitute for the weighings and results shown following\*.

## PUZZLE

A bowling league operates from fall to spring. Each team bowls two games with one other team every Friday night. One point is awarded for each game won, one point for total pins, one-half point for ties in game or totals. On February 11, 1949 the standing was as follows:

A	34
B	30
C	30
D	29

E	28
F	28
G	28
H	27
I	26
J	25

What is the date of the last scheduled game of the 1948-49 season?  
*(Our thanks to Mr. H. W. Baldwin, C.A., Hamilton, for the above puzzle. The solution will appear next month.)*

## PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect of course the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

## PROBLEM 1

## Final Examination, November 1948

*Accounting I, Question 5 (25 marks)*

The B Company Limited, a Dominion Company, is a progressive firm which has a well established manufacturing and trading business and in addition has acquired a controlling interest in the C Company Limited and D Company Limited, through the purchase of their shares in the open market.

The president of B Company Limited, representing the directors, advises the auditor of the company that as a result of extensive additions to plant and equipment during the past few years, the company finds itself short of working capital. In order to correct this situation, the company has decided to enter into an underwriting agreement with a firm of investment dealers for the purpose of making an offer of securities to the public.

A prospectus being required, the auditor is requested to prepare a statement of earnings and his report thereon for insertion in the prospectus.

The B Company does not usually prepare its financial statements in consolidated form but carries its investment in subsidiary companies on its balance sheet at cost. Earnings of subsidiary companies are taken up in the books of the parent company as revenue from investments, to the extent of dividends received.

After investigation the statement shown as Exhibit I was prepared.

The auditor of B Company Limited is not the auditor of the subsidiary companies but has been given Statements of Earnings supplied by their auditors in the form requested which are shown as Exhibits II and III. Adjustments affecting prior years have been recorded in the years to which they apply, and unrealized profits have been excluded.

Upon further investigation the following information was revealed with respect to the B Company Limited:

- (a) For the years prior to 1945 the company valued its inventories at cost based upon the "last in, first out" principle.

For the fiscal year ended 30th September 1945 the company changed over to the "average cost" basis. Throughout the period the company estimated its liability for income and excess profits taxes on the basis of inventories valued at "average cost".

For the years affected, the inventories were as follows:

	Basis "Last In, First Out"	Basis "Average Cost"
30th September 1942 .....	\$50,000	\$60,000
30th September 1943 .....	55,000	70,000
30th September 1944 .....	60,000	85,000

- (b) Final assessments covering income and excess profits taxes for the years 1943 to 1946 inclusive, have since been received as follows:

Year ended	Income and Excess Profits Taxes— Assessed	Refundable Portion of Excess Profits Tax —Assessed
30th September 1943 .....	\$39,500	\$ 3,750
30th September 1944 .....	62,750	5,200
30th September 1945 .....	92,000	12,500
30th September 1946 .....	79,500	

The company has not adjusted the over-provision for taxes in view of the possibility of receiving assessments for 1947 and 1948 which exceed the company's provision. To the best of the auditor's knowledge and belief the tax provisions for 1947 and 1948 are correct and agree in principle with the assessments of prior years.

- (c) On 30th September 1942, B Company Limited owned 55% of the stock of C Company Limited. In January 1946 it acquired an additional 20%. On 30th September 1942 B Company Limited owned 65% of the stock of D Company Limited. In January 1945 it acquired an additional 10%.
- (d) Dividends which were declared and paid by the subsidiary companies were included in revenue from investments of the B Company Limited in proportion to its stock holdings. Dividends were declared as follows:

Date Dividends Declared	Date Dividends Paid or Payable	C Company Ltd.	D Company Ltd.
30th Sept. 1944	31st Jan. 1945	\$10,000	\$15,000
30th Sept. 1945	31st Jan. 1946	15,000	25,000
30th Sept. 1946	31st Jan. 1947	nil	25,000
30th Sept. 1947	31st Jan. 1948	10,000	30,000
30th Sept. 1948	31st Jan. 1949	25,000	50,000

**Required:**

(a) The statement of consolidated earnings, including such figures as should be shown in the form in which it should appear in the prospectus with explanatory notes if considered necessary and the auditor's report thereon.

(b) Your working sheets showing how you arrive at your figures including a brief note of any assumptions you may have made.

*See below for Exhibits I, II and III.*

**EXHIBIT I**  
**B COMPANY LIMITED**  
**STATEMENT OF EARNINGS FOR THE SIX YEARS**  
**Ended 30th September 1948**

	1948	1947	30th September		1944	1943
			1946	1945		
Net profits before depreciation and other charges enumerated below .....						
Revenue from investments	\$275,000	\$215,000	\$165,000	\$185,000	\$135,000	\$110,000
	39,250	26,750	39,500	29,000	12,500	12,000
	<u>\$314,250</u>	<u>\$241,750</u>	<u>\$204,500</u>	<u>\$214,000</u>	<u>\$147,500</u>	<u>\$122,000</u>
Provision for depreciation	\$ 50,000	\$ 40,000	\$ 30,000	\$ 30,000	\$ 25,000	\$ 20,000
Interest on bonds .....	1,125	1,800	2,100	2,400	2,700	3,000
Loss on sales of investments		12,000		10,000		20,000
Provision for income and excess profits taxes* .....	100,000	95,000	82,000	94,000	67,000	42,000
	<u>\$151,125</u>	<u>\$148,800</u>	<u>\$114,100</u>	<u>\$136,400</u>	<u>\$ 94,700</u>	<u>\$ 85,000</u>
Net profit for the year transferred to surplus ....	<u>\$163,125</u>	<u>\$ 92,950</u>	<u>\$ 90,400</u>	<u>\$ 77,600</u>	<u>\$ 52,800</u>	<u>\$ 37,000</u>
*Includes refundable portion of excess profits tax .....				\$ 13,000	\$ 6,800	\$ 4,000

**EXHIBIT II**  
**C COMPANY LIMITED**  
**STATEMENT OF EARNINGS FOR THE SIX YEARS**  
**Ended 30th September 1948**

	1948	1947	30th September		1944	1943
			1946	1945		
Net profit before depreciation and other charges enumerated below .....						
Revenue from investments	\$ 68,000	\$ 52,000	\$ 40,000	\$ 44,000	\$ 30,000	\$ 24,000
	7,600	7,600	7,200	6,800	6,400	6,000
	<u>\$ 75,600</u>	<u>\$ 59,600</u>	<u>\$ 47,200</u>	<u>\$ 50,800</u>	<u>\$ 36,400</u>	<u>\$ 30,000</u>
Provision for depreciation	\$ 20,000	\$ 16,000	\$ 16,000	\$ 12,000	\$ 12,000	\$ 12,000
Loss on sale of fixed assets			10,000			
Provision for income and excess profits taxes* .....	24,000	24,000	20,000	22,000	14,000	10,000
	<u>\$ 44,000</u>	<u>\$ 40,000</u>	<u>\$ 46,000</u>	<u>\$ 34,000</u>	<u>\$ 26,000</u>	<u>\$ 22,000</u>
Net profit for the year transferred to surplus ....	<u>\$ 31,600</u>	<u>\$ 19,600</u>	<u>\$ 1,200</u>	<u>\$ 16,800</u>	<u>\$ 10,400</u>	<u>\$ 8,000</u>
*Includes refundable portion of excess profits tax .....				\$ 3,200	\$ 1,500	\$ 1,200

**EXHIBIT III**  
**D COMPANY LIMITED**  
**STATEMENT OF EARNINGS FOR THE SIX YEARS**  
**Ended 30th September 1948**

	1948	1947	30th September 1946	1945	1944	1943
Net profit before depreciation and other charges enumerated below .....	\$132,000	\$136,000	\$104,000	\$120,000	\$ 84,000	\$ 68,000
Provision for depreciation	\$ 28,000	\$ 28,000	\$ 24,000	\$ 24,000	\$ 20,000	\$ 16,000
Interest on bonds .....	4,000	4,000	4,000	6,000	6,000	6,000
Amortization of bond discount .....	400	400	400	.....	.....	.....
Provision for income and excess profits taxes* .....	40,000	60,000	48,000	64,000	42,000	28,000
	<u>\$ 72,400</u>	<u>\$ 92,400</u>	<u>\$ 76,400</u>	<u>\$ 94,000</u>	<u>\$ 68,000</u>	<u>\$ 50,000</u>
Net profit for the year transferred to surplus ....	<u>\$ 59,600</u>	<u>\$ 43,600</u>	<u>\$ 27,600</u>	<u>\$ 26,000</u>	<u>\$ 16,000</u>	<u>\$ 18,000</u>
*Includes refundable portion of excess profits tax .....				\$ 9,600	\$ 4,400	\$ 2,800

NOTE: Candidates were required to attempt either Question 5 (above) or Question 6 (see Problem II below).

**SOLUTION**  
**WORKING PAPERS — CONSOLIDATED EARNINGS B COMPANY LIMITED**  
**AND SUBSIDIARIES**

	1948	1947	1946	1945	1944	1943
Net Profits before Depreciation and other charges, no adjustment for Minority Interests:						
B Company Limited .....	\$275,000	\$215,000	\$165,000	\$185,000	\$135,000	\$110,000
Adjusting all inventories to "average cost" basis .....				x(25,000)	10,000	5,000
C. Company Limited .....	68,000	52,000	40,000	44,000	30,000	24,000
D. Company Limited .....	132,000	136,000	104,000	120,000	84,000	68,000
To Consolidated Statement	<u>\$475,000</u>	<u>\$403,000</u>	<u>\$309,000</u>	<u>\$324,000</u>	<u>\$259,000</u>	<u>\$207,000</u>
Revenue from Investments:						
B. Company Limited .....	\$ 39,250	\$ 26,750	\$ 39,500	\$ 29,000	\$ 12,500	\$ 12,000
C Company Limited .....	7,600	7,600	7,200	6,800	6,400	6,000
Less: Dividends from C						
Company Ltd. ....	(7,500)		(8,250)	(5,500)		
Dividends from D						
Company Ltd. ....	(22,500)	(18,750)	(18,750)	(9,750)		
To Consolidated Statement	<u>\$ 16,850</u>	<u>\$ 15,600</u>	<u>\$ 19,700</u>	<u>\$ 20,550</u>	<u>\$ 18,900</u>	<u>\$ 18,000</u>

## Provision for Depreciation

B Company Limited .....	\$ 50,000	\$ 40,000	\$ 30,000	\$ 30,000	\$ 25,000	\$ 20,000
C Company Limited .....	20,000	16,000	16,000	12,000	12,000	12,000
D Company Limited .....	28,000	28,000	24,000	24,000	20,000	16,000
To Consolidated Statement	<u>\$ 98,000</u>	<u>\$ 84,000</u>	<u>\$ 70,000</u>	<u>\$ 66,000</u>	<u>\$ 57,000</u>	<u>\$ 48,000</u>

## Interest on Bonds:

B Company Limited .....	\$ 1,125	\$ 1,800	\$ 2,100	\$ 2,400	\$ 2,700	\$ 3,000
D Company Limited .....	4,000	4,000	4,000	6,000	6,000	6,000
To Consolidated Statement	<u>\$ 5,125</u>	<u>\$ 5,800</u>	<u>\$ 6,100</u>	<u>\$ 8,400</u>	<u>\$ 8,700</u>	<u>\$ 9,000</u>

## Loss on Fixed Assets Sales

—C Company .....			\$ 10,000			
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## Loss on Investments, Sales

—B Company .....		\$ 12,000		\$ 10,000		\$ 20,000
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Provision for Income and  
Excess Profit Taxes:

B Company Limited .....	\$100,000	\$ 95,000	\$ 79,500	\$ 92,000	\$ 62,750	\$ 39,500
C Company Limited .....	24,000	24,000	20,000	22,000	14,000	10,000
D Company Limited .....	40,000	60,000	48,000	64,000	42,000	28,000
To Consolidated Statement	<u>\$164,000</u>	<u>\$179,000</u>	<u>\$147,500</u>	<u>\$178,000</u>	<u>\$118,750</u>	<u>\$ 77,500</u>

WORKING PAPERS — CONSOLIDATED EARNINGS B COMPANY LIMITED  
AND SUBSIDIARIES

For years ending 30th September

	1948	1947	1946	1945	1944	1943
Refundable portion Excess Profit Taxes						
B Company Ltd. ....				\$ 12,500	\$ 5,200	\$ 3,750
C Company Ltd. ....				3,200	1,500	1,200
D Company Ltd. ....				9,600	4,400	2,800
				<u>\$ 25,300</u>	<u>\$ 11,100</u>	<u>\$ 7,750</u>
Less: Minority Interest .....				3,840	2,215	1,520
To Consolidated Statement				<u>\$ 21,460</u>	<u>\$ 8,885</u>	<u>\$ 6,230</u>

x Assumed that in changing policy of Inventory valuation the \$25,000 adjustment was not made in respect of 1945 opening Inventory.



## CALCULATION OF MINORITY INTERESTS

C Company Limited				D Company Limited				Consolidated	
		Minority				Minority		Minority	
		Refundable				Refundable		Refund-	
Year	age	Profits	E.P.T.	Year	age	Profits	E.P.T.	Profits	E.P.T.
1943	45%	\$3,600	\$ 540	1943	35%	\$ 6,300	\$ 980	\$ 9,900	\$1,520
1944	45%	4,680	675	1944	35%	5,600	1,540	10,280	2,215
1945	45%	7,560	1,440	1945	25%	6,500	2,400	14,060	3,840
1946	25%	300		1946	25%	6,900		7,200	
1947	25%	4,900		1947	25%	10,900		15,800	
1948	25%	7,900		1948	25%	14,900		22,800	

Note: Minority interests in C Company 1946 profits and in D Company 1945 profits calculated on basis of interests at end of years.

## B COMPANY LIMITED

STATEMENT OF CONSOLIDATED EARNINGS  
For years ended 30th September

	1948	1947	1946	1945	1944	1943
Net Earnings before Depreciation, Interest and Taxes on Income .....	\$475,000	\$403,000	\$309,000	\$324,000	\$259,000	\$207,000
Add Revenue from Investments .....	16,850	15,600	19,700	20,550	18,900	18,000
	491,850	418,600	328,700	344,550	277,900	225,000
Less:						
Provision for Depreciation	98,000	84,000	70,000	66,000	57,000	48,000
Interest on Bonds .....	5,125	5,800	6,100	8,400	8,700	9,000
Amortization of Bond Discount .....	400	400	400			
Provision for Taxes on Income .....	164,000	179,000	147,500	178,000	118,750	77,500
Net Earnings for year including Minority Interest .....	224,325	149,400	104,700	92,150	93,450	90,500
Less: Minority Interest .....	22,800	15,800	7,200	14,060	10,280	9,900
Consolidated net earnings for year .....	\$201,525	\$133,600	\$ 97,500	\$ 78,090	\$ 83,170	\$ 80,600

Note: 1. Consolidation interest in refundable portion of Excess Profits Tax is included above in the amounts of: 1945, \$21,460; 1944, \$8,885; 1943, \$6,230.

2. The Earnings shown above do not take into account:

1. Loss on sale of Fixed Assets in 1946, \$7,500.

2. Loss on sale of Investments in 1947, \$12,000; 1945, \$10,000; and in 1943, \$20,000.

We have examined the books and records of the B. Company Limited and the statements of its subsidiary companies as certified by the auditors of these companies for the six years ended 30th September, 1948. In our opinion the above statement correctly reflects the consolidated earnings of the B. Company Limited, and its subsidiary Companies C & D, for the six years ended 30th September, 1948.

(Signed) .....

Date

Place

## PROBLEM 2

Final Examination, November 1948

Accounting I, Question 6 (25 marks)

The XPU Company Limited operates a street railway system in the City of XYZ. On 1st January 1945, the company entered into a new franchise agreement with the City, under the terms of which the company may make a maximum profit of 5% on its assets "used and useful in the public service." Any profit above this amount is to be turned over to the City of XYZ, in payment of franchise. If this amount exceeds \$10,000 in any year, then the rates are to be revised downward. If at any time revenues are so low that no franchise payment can be made, then the rates may be revised upward the following year.

The city council feels more profit is being earned than would appear from the statements, and the city auditor is asked to make an investigation of the company's affairs to determine if passenger fares could be reduced, and if the payments received by the City are those which should have been received according to the terms of the agreement.

The following statements are handed to the auditor:

## XPU COMPANY LIMITED

## BALANCE SHEET

As at 31st December 1947

## Assets:

## Capital assets:

Road and equipment as appraised on 31st December 1944 by Mark M. Upp Appraisal Company*	\$2,500,000
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## Investments:

Dominion of Canada and provincial bonds to be expended on renewals and expansions when equipment available	\$ 976,800
Employees pension fund	850,200
	1,827,000

## Current and working assets:

Inventories of operating supplies	\$ 81,700
Working funds advanced to conductors, etc.	2,760
Prepaid expenses	2,120
Accounts receivable	16,400
Cash on hand and in banks	370,360
	473,340
	\$4,800,340

## Liabilities and Reserves:

## Capital account:

Common stock, 5,000 shares @ \$100	\$ 500,000
(authorized, 5,000 shares @ \$100)	
5% Mortgage bonds payable	500,000
(Principal due 1950)	

Reserve for depreciation (computed on cost to the company)	840,790
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## Other reserves:

For redemption of outstanding tickets	\$ 5,620
For workmen's compensation and public liability	225,100
For modernization and expansion of system	175,740
For contingencies	161,000
For employees' pensions	850,200
	1,417,660

## Current liabilities:

Bond interest due 1st January 1948 .....	\$ 25,000	
Accounts payable and accrued liabilities .....	382,230	
		407,230
Surplus .....		624,260
Appraisal surplus .....		510,400
		<u>\$4,800,340</u>

\*1. Observed depreciation at the date of appraisal was \$210,000.

2. Engineering and similar costs, estimated at 10% of the amount recorded as historical cost of the capital assets have been charged to expenses in prior years.

**XPU COMPANY LIMITED**  
**OPERATING STATEMENTS**  
 For years ended 31st December

	1945	1946	1947
<b>Revenue:</b>			
Passenger revenue .....	\$3,039,800	\$3,207,100	\$3,737,600
Interest on invested funds and bank balances .....	17,600	19,400	27,500
Sundry .....	24,000	26,300	30,500
Gross revenue .....	<u>\$3,081,400</u>	<u>\$3,252,800</u>	<u>\$3,795,600</u>
<b>Expenses:</b>			
Cost of electric current .....	\$ 639,400	\$ 647,100	\$ 807,500
Maintenance, repairs, administration, etc. ....	2,016,866	2,149,299	2,509,670
Provision for depreciation .....	198,960	198,960	198,960
Provision for workmen's compensation and public liability .....	54,200	71,600	80,200
Bond interest .....	25,000	25,000	25,000
Total expenses .....	<u>\$2,934,426</u>	<u>\$3,091,959</u>	<u>\$3,621,330</u>
Net revenue .....	\$ 146,974	\$ 160,841	\$ 174,270
<b>Less:</b>			
Provision for contingencies .....	25,000	25,000	25,000
Provision for modernization and expansion of system .....	30,000	36,000	41,000
5% of net assets to surplus .....	82,774	90,341	98,570
Balance transferred to City of XYZ .....	<u>\$ 9,200</u>	<u>\$ 9,500</u>	<u>\$ 9,700</u>

**Required:**

(a) Outline the additional information the auditor would require with respect to the foregoing data.

(b) Indicate the points which should be covered in the auditor's report to the city council.

(c) Those statements (which give effect to the assumptions contained in (a)) required to support the opinion which will be expressed in the auditor's report.

Note: Candidates were required to attempt either Question 5 (see Problem I) or Question 6 (above)

## SOLUTION

(a)

- (1) The auditor would have to determine the items to be included within the definition "used and useful in the public service". It is assumed that these assets would be the capital assets, less depreciation, plus working capital to cover one month's operating supplies. It is also assumed that the 5% is to be calculated on the assets as at the beginning of the year.
- (2) The auditor would determine whether the statements submitted are correct per the books and records, and whether the books and records are correctly and accurately kept on a consistent basis (i.e., expenses not capitalized, capital items not charged off to expense, depreciation correctly and consistently calculated, inventories consistently evaluated, effective accounting system in use, etc.)
- (3) The auditor would analyze the sundry revenues.
- (4) The auditor would analyze interest on invested funds and bank balances to determine the amount arising from assets excluded from the definition above. It is assumed that this interest is on investments held for future extensions.
- (5) The auditor would analyze workmen's compensation and public liability to determine if:
  - workmen's compensation provision is carried by the company or by a government bureau.
  - the provision is reasonable in relation to the premium that would be paid to an insurance company for reasonable coverage in this respect.
  - it is assumed that workmen's compensation portion of this item is paid to a Workmen's Compensation Board and that the balance in the reserve is in respect of public liability only. It is also assumed that the amount is fair in the circumstances.
- (6) The auditor would analyze fixed assets and depreciation accounts to review all changes. No recognition should be given to engineering charges not included, because the company is deemed to have recouped these charges through charges to revenue in prior years. It is assumed that the depreciation rates are based on cost, and are reasonable in the circumstances.
- (b) The report should set out the scope of the investigation and set out an opinion in respect of fares, the amount which is due to the city and the reasons therefor. The report should give a summary of the statements supporting the opinion.  
 Note: Revised earnings for 1947 are approximately \$100,000 in excess of the amount permitted under the terms of the agreement, and fares for 1948 should be reduced. In order to bring the earnings to those permitted, the fare rates would have to be adjusted downward by approximately 1%.

(c)

## THE XPU COMPANY LIMITED

CALCULATION OF AMOUNTS OWING CITY OF XYZ  
UNDER FRANCHISE AGREEMENT

for the years ending 31st December 1945, 1946 and 1947

	Year ending 31/12/1945	Year ending 31/12/1946	Year ending 31/12/1947
Revenue			
Passenger revenue .....	\$3,039,800	\$3,207,100	\$3,737,600
Sundry .....	24,000	26,300	30,500
Total Revenue .....	<u>\$3,063,800</u>	<u>\$3,233,400</u>	<u>\$3,768,100</u>

<b>Expenses</b>			
Cost of electric current .....	\$ 639,400	\$ 647,100	\$ 807,500
Maintenance, repairs, administration, etc. ....	2,016,866	2,149,299	2,509,670
Depreciation .....	198,960	198,960	198,960
Provision for Workmen's Compensation and Public Liability .....	54,200	71,600	80,200
<b>Total allowable expenses .....</b>	<b>\$2,909,426</b>	<b>\$3,066,959</b>	<b>\$3,596,330</b>
<b>Excess of total revenue over allowable expenses</b> .....	<b>\$ 154,374</b>	<b>\$ 166,441</b>	<b>\$ 171,770</b>
<b>Earnings allowed company .....</b>	<b>91,369.50</b>	<b>81,421.50</b>	<b>71,473.50</b>
<b>Amount payable to City of XYZ .....</b>	<b>63,004.50</b>	<b>85,019.50</b>	<b>100,296.50</b>
<b>Paid to city .....</b>	<b>9,200.00</b>	<b>9,500.00</b>	<b>9,700.00</b>
<b>Balance due City of XYZ .....</b>	<b>\$ 53,804.50</b>	<b>\$ 75,519.50</b>	<b>\$ 90,596.50</b>
<b>or a total of .....</b>			<b>\$ 219,920.50</b>
<b>Assets "used and useful"</b>			
Fixed Assets .....	\$1,989,600	\$1,989,600	\$1,989,600
Less—Depreciation reserve as at first of year .....	243,910	442,870	641,830
	\$1,745,690	\$1,546,730	\$1,347,770
Working capital allowance re operating supplies .....	81,700	81,700	81,700
<b>Total .....</b>	<b>\$1,827,390</b>	<b>\$1,628,430</b>	<b>\$1,429,470</b>
<b>5% thereof .....</b>	<b>\$ 91,369.50</b>	<b>\$ 81,421.50</b>	<b>\$ 71,473.50</b>

### VERIFICATION OF INVENTORIES

A suggested answer to a question asking what steps should be taken to obtain a substantial verification of the book balance of the physical quantity in a large outdoor pile of coal, *The Journal of Accountancy* (February 1949) gives the usual answer of determining the cubic content and subsequent conversion to tons, having regard to ground level and uniformity of packing.

As a result of a personal experience with a railway pile in Northern Ontario, one should also add that there should be included a guess of the amount of coal which has sunk below the ground level. This can be quite an important item. The only sure method is to move the pile so that it does not require measurement and then measure what you can raise with a steam shovel.

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